The Regulation of Financial Intermediaries

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Institute of Law and Economics
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The regulation of financial intermediaries

1. Practical relevance of the topic
2. Financial crisis – some lessons to learn
3. Efficient markets – theory
4. Status quo – reality
5. Institutions offering advice
6. Analysis – why markets fail
   a) Choice of financial products
   b) Choice of advisor
7. Policy recommendations
   a) Focusing on products?
   b) Alternative: Focusing on advice
Practical relevance

Consumer perspective

- Increasing importance of private saving for individuals
  - Low birth rates in western countries
  - Promotion of private saving schemes through governments
  - Increasing private wealth

- High complexity of decision making, growing variety of financial products
- Limited cognitive abilities of individuals

Economic dimension

- Magnitude of private saving in Germany in 2007: € 4563 billion assets (€ 1620 billion in liquid assets; € 1143,8 billion in shares etc.; € 1164,6 billion in insurance, € 261,6 billion in pension claims and € 330,8 billion in bonds)
- Estimated costs of inefficient asset allocation: tens of billions euro per year
The financial crisis – some lessons to learn

• Complexity of financial products can cause problems
• Unlimited freedom in designing them, too
• Limited rationality of individuals
• Key function of the level of sales and distribution
• Need for at least some regulation
• Political importance of distributitional aspects
• Limits of pure ex post-regulation
Efficient markets - theory

Preliminary findings

- Consumers should seek expert advice, not decide on their own
- Consumers should be able to completely rely on expert advice
- Consumers need advice that suits their interests (not the interests of banks, insurance companies or intermediaries)
- Efficient markets should provide such advice at low costs
- In the end, consumers should receive products that suit their needs

Arguments

- Transaction costs, division of labor, limited rationality
- It is always the consumer who pays for the advice with his fee/premium
- Products that don’t suit consumer preferences are inefficient
Banking and insurance products

- Sale of unsuitable products (leading to inefficient portfolios)
  - Illustration: household insurance versus liability insurance
- Sale of unnecessarily expensive products
  - Illustration: index funds versus actively managed funds

Market for financial advice (distributional level)

- Clear dominance of firmly tied, non-independent advisors
- Bad advice leads to huge economic damages
  - Sale of inefficient products (see above)
  - Unnecessarily expensive financial advice
Various types of advisors

- Banks/insurance firms (direct or via own agencies/agents)
- Independent but tied agents
- Brokers
- Freelancers (lawyers, chartered accountants, tax consultants)
- Other ("Versicherungsberater" etc.)

Three categories

- Truly impartial advice
- Legally ordered impartiality – but with bad incentives
- Tied agents, employees of banks/insurance firms etc.
Choice of financial products

• Transaction costs (high complexity, some information available only to banks/insurance firms)
  – Illustration: surplus sharing in life insurance
• Credence qualities of banking and insurance products
  – Difficulties to assess the quality even after obtaining the product
  – As a consequence, classical institutions such as guaranties, disclosure etc. may not help
  – Consumers often don’t know what to pay attention to and what to ask
  – Illustration: investment funds
  – Illustration: capital-life insurance versus life insurance
• Cognitive limitations (irrationality)
Choice of advisor

• Transaction costs (in seeking the right intermediary)
  – Advisors with problematic incentives try to hide their true interests with great effort

• The credential properties of bank and insurance products hinder various institutions (guaranties etc.) that would otherwise ensure quality of advice
  – Illustration: reimbursement schemes (e.g. with profit sharing)

• Legal hindrances: some countries deny intermediaries the right to forward the commission received from insurance companies to consumers

• Elements of irrationality: Humans are very hesitant to pay for ‘immaterial’ services such as financial advice (in contrast to tangible products)
Focusing on products?

- Regulating the content of financial products
  - Advantages: e.g. high degree of control and security; greater market transparency
  - Disadvantage: e.g. lack of innovative and custom-tailored products
  - Illustration: Regulation of insurance products in Germany: 1910 - 1956 – 1993

- Disclosure duties
  - Classical European approach (‘information model’)
  - Advantages: doesn’t limit the variety of financial products, relatively easy to implement in various member states
  - Disadvantages: limited ability of individuals to process that information, consumer still has to decide on his own, a bank or intermediary with interests contrary to those of the consumer will always find ways to deliver its/his own message, lack of legal certainty for those who have to advise, scope of disclosure limited to own products
Policy recommendations

Alternative: Focusing on advice

- Rules on various aspects of advice giving
  - Interests, especially compensation (fees versus commissions etc.) – critical aspect
  - Disclosure duties
  - Qualification – not the most decisive factor, obligatory standards should remain modest
  - Professional liability insurance
  - Centralized registration of intermediaries

- Transparency of the above mentioned aspects (‘amplified information model’)
  - Very little information to process for consumer: ‘type A-advisor = good; type B-advisor = bad’
  - As it is efficient/rational to rely on an advisor this information is essential in contrast to various details of financial products

- Differentiation according to the advisor’s status
Focusing on advice (cont.)

• Especially important: transparency of interests
  – Clear distinction of truly impartial advisors and other groups, creation and protection of respective labels (‘Type A-advisor’ etc.)
  – Clear disclosure of commissions and other fees, separate payment of commissions
  – Encouragement of hourly fees or fixed rates directly paid by the consumer

Thank you for your attention!