Markets with Advice:
A Framework for Consumer Protection

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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.
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Policy Debate on Consumer Protection

US Treasury proposal of Consumer Financial Protection Agency (CFPA):

“To address this problem, we propose granting the CFPA authority to impose carefully crafted duties of care on financial intermediaries. For example, the CFPA could impose a duty of care to counteract an intermediary’s patent conflict of interest, or to align an intermediary’s conduct with consumers’ reasonable expectations as demonstrated by empirical evidence.
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UK Financial Services Authority proposal of complete switch to direct pay for advice:

“. . . require advisor firms to be paid by advisor charges”
“. . . not allow adviser firms to receive commissions offered by product providers”
Intermediary

Commissions

Information on match of products’ characteristics with customer’s needs

Products

Purchase decision

Payment for product

Advice

Customer

A

B
Our Agenda

- Intermediary’s tasks:
  1. To **find** customers
  2. To **acquire information** about suitability of customers to products
  3. To **advise** customers

Customers’ rationality:
1. Naive, who trust advice
2. Wary, who are aware of conflict of interest
3. Mixed population: uniform & (2nd degree) discriminatory pricing

Positive predictions about:
- Pricing structure for product (ex ante v. ex post payment)
- Compensation structure for advisor (indirect v. direct)
- Voluntary disclosure

Normative impact on consumer and social welfare induced by:
- Suitability regulation
- Bans of commissions
- Mandatory disclosure of commissions
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1] Sales Talk, Cancellation Terms, and the Role of Consumer Protection

Timing:

1. Seller sets:

- Seller sets the price for the product and the refund for cancellation/return.
- Seller observes a signal about the suitability of the product for the customer.
- Seller directly advises the customer whether to buy.
- The customer decides whether to buy.
- The customer observes the ex post utility.
- The customer decides whether to cancel or return the product.
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With WARY CUSTOMERS, compared to first best:

- excessively lenient sales standard EX ANTE
- excessively generous cancellation terms EX POST
- nevertheless, equilibrium is second-best efficient
- competition policy is effective, but consumer protection detrimental
• **Exploitation** value of restrictive cancellations terms:

  - Credulous buyers underestimate the probability of having to cancel later compared to the seller. Thus, the seller can exploit these inflated perceptions induced in the buyer by offering overly restrictive cancellation terms and extract all the buyer's perceived consumer surplus through the initial price. The buyer is then left with a negative true consumer surplus!

  - With credulous customers, we find that advice allows the seller to inflate expectations about the product's value. The seller then extracts more profits through inefficiently restrictive cancellation terms.

  - Consumer protection policy is effective, whereas competition policy can be counterproductive, because it worsens the quality of advice.
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2] Advice in Retail Finance

- When making financial decisions (mortgages, insurance, consumer credit, and investments), investors receive advice.
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  - 80% of mutual fund investors in the US [2005] & 90% of bank customers in Europe [2003]
- Investors trust advice they receive from brokers & financial advisors
  - In Austria, Germany, and Finland, 70% of bank customers report to trust advice [2003]
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Persistent claims of unsuitable advice

- US mutual funds with higher fees have higher commissions & underperform; Bergstresser & al (2007), Edelen & al (2008), Chen & al (2007)
Evidence from ARMs (Adjustable-Rate Mortgages)

Bergstresser and Beshears (2010)

- Evidence from the 1989-2007 Survey of Consumer Finances on:
  - respondents' ability to comprehend financial questions
  - degree to which respondents were suspicious in the interview

In 2004-2007, borrowers with lower comprehension and less suspicion are more likely to purchase ARMs. ARMs exhibited higher rates of foreclosure than fixed rate mortgages (FRMs) during the mortgage crisis.
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2] How (Not) to Pay for Advice

Products

A monopolist

B competitive

Commissions $T_A, t_A$

Intermediary

Information on match of products’ characteristics with customer’s needs

Price $p_A$

Advice

Fee $f$

Purchase decision

Customer
2] Demand & Information: Mapping to Hotelling
Higher information acquisition effort results in a mean-preserving rotation of posterior distribution

\[
\frac{dG(q \mid e)}{de} > 0 \text{ for } q < q_0, \quad \frac{dG(q \mid e)}{de} < 0 \text{ for } q > q_0,
\]
corresponding to a Blackwell more informative experiment
2] How (Not) to Pay for Advice

Figure 1: Timeline.
Compensation structure for advice serves two purposes:

- Exploiting naive customers
- Inducing information acquisition

For channels/products dominated by wary customers, we predict:

- Indirect compensation for advice
- Banning commissions is not socially optimal
- Sellers indifferent to disclosing commissions

For channels/products dominated by naive customers, we predict:

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