European Business Organization Law Review 13: 237-246

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doi:10.1017/S156675291200016X

Regulating Financial Advice

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Abstract
Motivated by recent policy changes across many countries, this paper discusses the rationale for various policies that target financial advice in the market for retail financial services. To set the stage, we review recent findings on how retail financial consumers make use of professional financial advice. Based on our own research, as well as other recent contributions in the economics literature, we then discuss the pros and cons of, in particular, policies that target the disclosure as well as the size and structure of commissions.

Keywords: financial advice, consumer protection, commissions, disclosure.

1. MOTIVATION

The regulation of the financial industry is presently being scrutinised in many countries. Farther-reaching protection of retail financial consumers is one of the key objectives. In Europe, the newly created Financial Stability Board (FSB) has made several proposals on how to advance consumer finance protection, such as the establishment of dedicated consumer protection authorities (FSB 2011). In the US, the Consumer Financial Protection Bureau has been operational since July 2011. In the UK, the newly created Financial Conduct Authority will take over responsibilities from the present Financial Services Authority.

* Johann Wolfgang Goethe University, Frankfurt/Main. Financial support from the ERC Grant Agreement 229921 – RNF is gratefully acknowledged.

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https://doi.org/10.1017/S156675291200016X Published online by Cambridge University Press

The provision of financial advice is one of the main areas where regulation is being redrafted. Rather than helping consumers, it is argued that, at present, advice from conflicted parties is often to consumers' detriment. This view is reflected in the European Commission's present proposal for a new Markets for Financial Instruments Directive (MiFID II), which addresses such conflicts of interest through a ban on specific forms of contingent payments. Until now, MiFID I, in place since January 2008, has only imposed disclosure requirements. Such a tougher stance follows similar policies in the UK and the US.[1]

In this article, based on our own research in this area, we review several policies targeted at financial advice. To set the stage, section 2 reviews some of the academic literature that documents how consumers make use of financial advice. But advice may not always be in consumers' best interest. Section 3 discusses when and why one should expect that biased advice survives in the marketplace, unless policy intervenes. Sections 4 and 5 continue by discussing various policy interventions, such as mandatory disclosure of commissions or restrictions on how advisers are paid or contracts with consumers are structured (e.g., through imposing minimum statutory rights to cancel contracts). Section 6 concludes with a broader outlook on consumer protection in retail financial markets.[2]

2. PROFESSIONAL ADVICE IN THE MARKET FOR RETAIL FINANCIAL SERVICES

For many financial products the respective decision space of consumers is vast. Take the case of investment products, where consumers have to decide when and how much to save, as well as in what asset classes to invest, even before choosing the specific products. They then have to decide when and how often to review their investment, e.g., in order to rebalance their portfolio. Here, the product space is large and products targeted at retail investors are by no means simple but may involve complicated derivative structures. But even for simple product classes, prices, in the form of additional expenses and fees, seem to vary substantially, which makes search difficult and time consuming and may itself be an expression of lack of transparency.[3]

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[1] In both countries, certain compensation practices related to the distribution of retail financial products are already forbidden, for instance, in the US, dual compensation of loan originators or compensation of mortgage brokers based on the terms and conditions (other than size) of the loan.

[2] Inderst and Ottaviani (2010) provide a more general discussion of consumer protection in markets for advice (i.e., not limited to financial products). Hackethal and Inderst (2012) focus on recent empirical work dealing with financial advice. Inderst and Ottaviani (forthcoming B) treat much of the material that is presented in this article in a more formal way.

[3] For instance, Hortaçsu and Syverson (2004) find significant variations in expense ratios among (homogeneous) S&P 500 index funds.

https://doi.org/10.1017/S156675291200016X Published online by Cambridge University Press

Retail financial consumers may often lack the most basic financial knowledge. 'Learning by doing' may be hard or even impossible, in particular if basic cognitive or numeracy skills are lacking and basic concepts such as inflation or compounded interest are not understood. Also, there is often only limited feedback when decisions for the long term are made, such as in the case of life insurance policies.

There is thus, in a nutshell, considerable scope for professional financial advice to help consumers with particular recommendations or just by explaining product features. Indeed, retail financial consumers generally seek and receive advice. In a large online survey among recent purchasers of investment products in the EU that was conducted by Chater, Huck and Inderst (2010), almost 60 per cent reported that their choice was directly influenced by an adviser.

Several studies document that more (financially) educated consumers seek more professional advice (cf., Hackethal, Haliassos and Jappelli, 2010; Van Rooij, Alessie and Lusardi, 2007). Consumers who are less sophisticated may however be more dependent on advice, so that professional financial advice may be particularly important for less financially capable households. Hackethal, Inderst and Meyer (2010) report that less knowledgeable customers of a large German bank rely more on financial advice, and they have a significantly larger turnover of their securities portfolio and a larger fraction of products in their portfolio for which their adviser received additional incentives. Georgarakos and Inderst (2010) use data from a Eurobarometer survey and show that trust in financial advice is a significant determinant of the willingness to hold risky assets for less educated households or households that find financial decisions more complex, but much less so for more educated and more confident households.

But financial advice may not always be disinterested. Consequently, consumers could be even worse off when relying on advice, or at least, when they do not have an alternative, the value of advice is seriously compromised. A well-functioning market for advice would ensure that the adviser's self-interest coincides – at least to a large extent – with that of consumers. This, however, seems not always to be the case. The recent financial crisis has put the spotlight on a number of cases of possible 'mis-selling' – of credit products as well as investment products. Often, the compensation of financial intermediaries creates distorted incentives. We turn to this issue in the following section.

3. CONFLICTS OF INTEREST

A key source of the aforementioned conflict of interest is that advisers frequently receive commissions or other contingent payments. At this point, we should note that for the purpose of this article we simply refer to financial advice or a financial adviser without having in mind particular professions, and thereby the particular legal requirements. Specifically, our discussion should apply equally to dedicated investment advisers or broker-dealers whose advice is legally considered to be

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'solely incidental' to their business. We focus on advice that is given specifically to a particular consumer, rather than being provided generically, for example, through an investment newsletter or an analyst report.

Consumers commonly pay 'indirectly' for advice, namely through higher product prices. The increment – or at least part of it – is then passed on to the respective adviser. When reputational concerns or liability do not impose a sufficiently strong constraint, this practice is bound to induce biased advice. Why then is it so common in practice?

Inderst and Ottaviani (forthcoming A) develop a model that endogenises the way consumers pay for advice. In the model, there are two types of consumers: naïve consumers and wary consumers. We first take the case where only naïve consumers are present in the market. These consumers are not aware of commissions or at least not of the way these can lead to biased advice. Alternatively, the presence and impact of commissions is not sufficiently salient at the time of purchase, though consumers may generally be aware that such contingent payments are made. When commissions are not disclosed, these naïve consumers fail to form rational expectations. In equilibrium, our model predicts that naïve consumers will pay for advice exclusively through higher product prices, which go hand in hand with higher commissions. This is the optimal response of firms to consumers' naiveté. Naïve consumers underestimate the likelihood with which they ultimately purchase a product (or, likewise, a product with a higher commission). Firms maximally exploit this misperception by charging consumers no fee for advice, but consumers pay higher product prices. Even though consumers seemingly do not pay for advice, they are seriously shortchanged through biased advice and higher product prices.

When the market is thus populated by such naïve consumers and when firms optimally respond by setting higher product prices and making contingent payments rather than charging consumers up-front for advice, there is possibly scope for policy intervention that can increase efficiency and make consumers better off. A cap on commissions, provided that a disclosure policy works as an 'eye-opener', could decrease consumers' misperception. However, such interference with contractual practices can backfire in markets where consumers are wary and where contingent payments are made for other reasons. Before exploring this, we briefly discuss whether we should indeed consider that at least some consumers are naïve about commissions and conflicts of interest.

Chater, Huck and Inderst (2010) show, in a survey among six thousand recent purchasers of retail investment products in Europe, that respondents are largely ignorant of conflicts of interest. More than half of the respondents thought that financial advisers or the staff of a tied provider gave completely independent advice or information. Only a minority believed or even knew that the intermediary through whom they purchased a product received a commission or a bonus for selling the investment. In various jurisdictions, advisers are now required to reveal conflicts of interest or even the specific inducements they receive, as discussed in the introductory remarks. Particularly in face-to-face situations, however, this information

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may not be sufficiently salient. Some consumers may indeed take recommendations at face value instead of correcting for the underlying conflict of interest.

As we pointed out, when consumers are naïve in this way and when disclosure of commissions is not sufficiently salient, policies that impose caps or a ban on commissions may be required to protect consumers. However, any policy that would interfere with business practice in this way is bound to reduce efficiency when contracts are designed not in order to exploit unaware and naïve consumers but rather in order to improve efficiency. Paying advisers a higher margin if their recommendation results in a sale may be efficiency enhancing, as it can induce advisers to acquire and communicate information. To illustrate this, consider an adviser who is only paid a fixed fee or by the hour and who is also little concerned with reputation. Consequently, such an adviser will not be much incentivised. Instead, if he can expect to earn a commission only if the consumer subsequently makes a purchase, this may motivate him to work harder in order to produce (verifiable) information that could convince the consumer to follow his recommendation.

Inderst and Ottaviani (forthcoming A) provide a more subtle argument for why contingent payments may enhance efficiency, which works also when the adviser's role is simply to provide a recommendation, rather than generate information that the consumer can then verify. In such a 'cheap talk' setting, where advice remains a 'credence good', the quality of advice is determined not only by the adviser's potential bias, but also by how much effort he exerts to generate information (e.g., information about the suitability of various products for the particular needs of a given consumer). We describe circumstances for when the 'second-best efficient' outcome involves contingent payments and thus biased advice, even though consumers are wary and thus expect the value of recommendations to be compromised in this way. The key insight is that such contingent payments can again lead to more information acquisition, which – at least when the bias is not too extreme – can more than make up for the resulting bias that is induced by contingent payments.

Caps on commissions or mandating that consumers negotiate with advisers a direct payment for advice may thus have both beneficial *and* detrimental effects. Whether policy-makers should interfere depends on whether consumers who buy the particular product through the particular sales channel are sufficiently wary of how advisers are compensated and what this entails in terms of conflict of interest. If mandatory disclosure of commissions makes also naïve consumers wary, then, in the discussed setting, such a less intrusive policy would be preferable.

At this point it should also be noted that when consumers are naïve, firms themselves may have no interest in educating consumers. To see this, note first that rival firms find it hard to compete when making consumers pay directly for advice because they cannot match the (wrongly) *perceived* utility that consumers expect to obtain with the prevailing practice of making consumers pay indirectly for advice. In other words, selling products under biased advice allows firms to generate the same perceived utility at lower cost. And firms are better off under biased advice even

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when there is competition: competition does not sufficiently protect consumers from exploitation. This is because consumers' inflated expectations make demand less elastic, which softens competition. Firms end up earning higher profits under biased advice, when there is competition and even though total surplus is lower.

4. MORE ON MANDATORY DISCLOSURE AND BANS ON COMMISSIONS

The preceding section discussed a particular (modelling) framework in which the equilibrium choice of contracts between consumers, product providers, and advisers is determined. The key distinction that we made was that between a setting with (mainly) naïve consumers and one with (mainly) wary consumers. The key policy instruments discussed are those of mandatory disclosure and capping or banning commissions. The various pros and cons of these policies have also been analysed in other work, some of which is reviewed in this section.

Lacko and Pappalardo (2004) suggest, based on experimental evidence, that disclosure of commissions could lead to information overload. This may prevent consumers from adequately digesting truly payoff-relevant information. In particular, they may overreact by avoiding products that are associated with high payments to the adviser. But this should be less likely when recommendations are given face to face so that there can be communication. Indeed, Chater, Huck and Inderst (2010) demonstrate this with an experiment where (student) advisers and (student) advisees could communicate (via keyboards). In another study that suggests that disclosure may have unintended consequences, Loewenstein, Cain and Sah (2011) show how advisers may think that biased advice is more legitimate and advisees may fear that their lack of adherence would signal outright distrust. This would suggest that disclosure leads to more rather than less biased advice and at the same time to more adherence.

The negative findings (regarding disclosure) from these experimental studies may however be less relevant in practice if advisers and consumers can quickly adjust to the new regime. In particular in markets where a large fraction of consumers currently seems to be unaware of the size and consequences of contingent payments, disclosure should prove beneficial, provided that it works at all, i.e., provided that it proves to be salient at the time advice is given and a purchase is made.

However, when consumers are wary of conflicts of interest, as induced by contingent payments, then, as we have already pointed out, policy interference can backfire. That this can be the case even with mandatory disclosure, and not only when commissions are capped or even banned, has been shown in Inderst and Ottaviani (2012). There, the focus is on commissions as an important instrument that steers demand to the most efficient products, which are also the products that, *ceteris paribus*, will command a higher margin and thus make it worthwhile for product providers to pay a higher commission. Inderst and Ottaviani (2012) show how disclosure can push up the market share of more efficient products. Wary consumers

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are not fooled in equilibrium, but non-disclosure of commissions leads to higher incentives to pay commissions. While thus all commissions will be higher without disclosure, this will be particularly so for the most efficient product. However, our formal analysis also shows that such a possible negative effect of mandatory disclosure will only prevail when advisers care much about the suitability of their advice.

Capped commissions or bans may lead to more serious inefficiencies when they do not protect consumers whose naïve beliefs are exploited without such intervention. This is particularly the case when contingent payments are made to incentivise an agent to conduct other tasks as well, e.g., that of serving customers more generally or providing information (cf., the previous discussion). Moreover, when a particular advising intermediary serves as agent to more than one product provider, there may be a 'free-riding' problem in some of these tasks. Most notably, as one product provider pays higher commissions to incentivise the agent to spend more time and effort to prospect for customers, the other product provider may also benefit to some extent, given that a potential customer may ultimately settle for his rather than the rival's product. In such circumstances, there may be *underprovision* of incentives through contingent payments in the marketplace, which a cap or ban would further exacerbate.[4]

5. FURTHER RESTRICTIONS ON CONTRACTS

So as to align the incentives of intermediaries with consumers, the compensation of the former could be targeted by policy in various ways. The most common proposals for such policies are to limit the steepness of incentives and to make incentives more long-term. Unfortunately, there is only very limited research in economics on how to regulate the split of compensation between up-front and trail commissions. That being said, some of the preceding discussion also applies to such policy. We discuss this next.

Take the case of short-term vs. long-term compensation. Generally, when contracts are long-term and may be cancelled by consumers or when the product provider receives, over time, more feedback on the suitability of his agent's advice, then, through postponing part of the agent's commissions, the firm can better align the interests of consumers with those of the agent. This may, however, be very costly, namely when the agent has high (time or liquidity) preferences for being paid out immediately. But when consumers are sufficiently wary and when they observe commissions, they may rightly infer that short-term and steep contingent payments lead to a lower quality of advice. This should result in a lower valuation of advice and thereby also of the respective products. Research by Inderst and Pfeil (forth-

[4] Such multi-tasking is analysed in Inderst and Ottaviani (2009).

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coming), though focused on bonus pay to bankers, suggests, however, that firms may not choose efficient contracts even when they can credibly communicate compensation and when they face fully rational and wary decision-makers. There is even larger inefficiency when consumers are naïve about incentives. In this case in particular, there can be a rationale for mandating that a fraction of compensation is postponed as a 'trail commission'.

Our present research also touches on other aspects of regulating contracts. When it takes consumers time to find out whether a particular product or service is suitable given their needs and preferences, they benefit from having the right to return the product or to cancel a contract. We formally analyse such a setting more generally in Inderst and Ottaviani (2008). With respect to retail financial products, this could apply to life insurance contracts or savings plans. When the initial decision whether to purchase a product or to enter into a contract was made after receiving the respective recommendation, generous rights of refund or cancellation could, in principle, help the seller or his agent to credibly signal to wary consumers that no unsuitable advice was given. Otherwise, i.e., when unsuitable advice was given, the product provider and his agent would subsequently face many costly terminations. A key insight in Inderst and Ottaviani (2008) is, however, that when consumers are again naïve about the incentives of the adviser, this mechanism does not work. On the contrary, non-generous and very restrictive terms of cancellation are then used as a tool to exploit consumers. We illustrate this insight next.

Take again consumers who are credulous and put too much faith in an adviser's possibly inflated statements. These consumers wrongly hold the belief that they will be unlikely to terminate a contract prematurely. In such case, firms can maximally exploit consumers' misperceptions by granting them very unfavourable terms of refund and cancellation. An immediate consequence is that advice will be extremely biased and that, in these circumstances, consumer surplus and welfare can both be increased by a policy that mandates minimum statutory rights of cancellation. Even when consumers remain naïve about the conflict of interest, this intervention reduces the extent to which their still inflated beliefs about a product's suitability, following an adviser's recommendation, are exploited.

6. CONCLUDING REMARKS

Retail consumers seek and receive professional financial advice. Advice can play a key role in improving efficiency, in particular given consumers' lack of financial capability. However, conflicts of interest can turn advice from a blessing into a curse for consumers, particularly if they are not sufficiently aware that contingent payments can result in conflicts of interest. Our research shows how consumer naiveté can be exploited through inefficient contractual practices. This creates scope for beneficial policy intervention. However, when consumers are sufficiently wary, policy intervention may backfire, in particular when commissions and other contin-

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gent payments serve to incentivise agents to assume different tasks as well. Policy intervention must thus take a balanced view regarding commissions.

But when policy intervention is called for, it must ensure that disclosure is a sufficiently strong eye-opener, particularly in the context of face-to-face advising. If such disclosure proves insufficient, policy must become more intrusive, e.g., by capping or banning commissions, but also by closely monitoring compensation practices and conduct. Still, commissions may serve important functions in the marketplace, such as steering recommendations and thus demand towards the most efficient products or generating incentives for information provision and customer service.

Any intervention should thus be preceded by careful analysis. To what extent are consumers in a given market and distribution channel unaware of conflicts of interest? Do consumers systematically treat sales talk as unbiased advice or fail to distinguish between those advisers who have a strong fiduciary duty and those who are merely brokers? It should also be asked whether there is the potential that certain policies may backfire, e.g., by pushing the industry towards arrangements in which conflicts of interest are less visible to consumers but possibly not less harmful, e.g., when product provision and (tied) advice are integrated.

On a final note, it should not be forgotten that the market itself can create incentives for the provision of good advice, provided that consumers can discern good from bad advice and act accordingly. For instance, in an analysis of the German market for retail investment services, Hackethal and Inderst (2011) noted that banks do not report to advised customers the risk and aggregate return of their securities investments. The authors propose to increase transparency by granting consumers the right to an electronic copy of their past transaction data, so that they or a third party can calculate performance measures and provide benchmarks. Based on these measures, there is at least a chance that the quality of advice can be assessed accordingly. Though presently such intervention may be seen more as being complementary to other policies, it would have the benefit of harnessing, in addition, market forces to increase transparency and thereby the quality of advice.

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