Some Challenges in Designing Investor and Borrower Protection

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Households: Getting into financial trouble

- Key environmental factors:
  - Demographic transition: being forced to make decisions you cannot handle
  - Financial innovation: being confronted with new products
  - Product complexity: being confronted with products you do not understand
  - Poor financial advice: “car mechanic principle” fails

- Key documented challenges at the individual level:
  - Widespread financial illiteracy *correlated* with bad financial outcomes
  - Limited awareness of, or familiarity with certain financial products
    - Problems with use and with non-use!
  - Poor matching between individuals and financial advisors
    - Those who need advice most are least likely to have an advisor
  - Possible negative influence of social interactions and comparisons
    - Spreading use of financial products and practices (good or bad?)
    - Growing indebtedness in response to social comparisons
  - Overtrading or inattention and portfolio inertia?
- Current research in household finance sheds light on these issues

The main thrust of regulation so far

- Ban the unfamiliar
  - Require familiarity checks (e.g., MIFID)
  - Ban sales of certain products (e.g., Belgian ban on structured products)
  - Implicit assumption
    - Lack of familiarity with a financial product **en**courages participation that later proves counterproductive or disastrous
  - One-sidedness: Lack of familiarity could **dis**courage participation
  - Paternalism and potential discrimination
    - Learning: Bans prevent individuals from gaining familiarity (contrast driver licenses)
    - Lack of familiarity could be offset through other channels
      - e.g., well-incentivized financial practitioners, interaction with knowledgeable peers: evidence?
- Legal focus so far:
  - Transparency: What information you must present
    - Transparency requirements boost volume of info
  - Who initiates the sanctions rather than who is being regulated
    - Institutional sanctions
    - Individual sanctions
  - Starting to separate selling from advising function
    - August 2014: Introduction of "fee only" financial advisors in Germany

- See also Faia, Hackethal, Haliassos, Langenbucher (Eds.), *Financial Regulation: A Transatlantic Perspective*, Cambridge University Press (September 2015).

Product Complexity

- Increased complexity may be a strategic action on the part of some producers of innovative financial products in the face of increasing competition.

  - Celerier and Vallee (2014) study 55,000 retail structured products issued in 17 European countries since 2002
    - Financial complexity has been steadily increasing, even after the financial crisis, especially among producers with a less sophisticated investor base
    - By comparing market price to the fair value of a number of these products, the authors find that the hidden markup in a product is an increasing function of its complexity.
    - They also find that complexity intensifies when competition increases.

Product awareness and Familiarity bias

- Guiso and Jappelli (2005):
  - Studied a sample of Italian households
  - Found that only about one third were simultaneously aware of the existence of stocks, mutual funds, and managed accounts

- Within a given asset class, households tend to be drawn to assets most familiar to them
  - Contributes to
    - home equity bias
    - or a preference for local stocks
  - E.g., Feldstein and Horioka (1980), Coval and Moskowitz (1999), Huberman, (2001)

Problems with focusing on reducing financial illiteracy

- There is ample evidence that financial illiteracy is present and disproportionately so for certain demographic groups, across a wide spectrum of countries.
  - For example, Lusardi and Mitchell (2007) showed that:
    - only 18% of US households aged 51-56 could calculate two-year interest compounding correctly
    - of the rest, only 43% simply failed to compound interest
    - Particularly acute problem in certain education and race groups

- Key question: Does financial illiteracy cause bad financial outcomes?
  - A number of authors have found that poor outcomes (lower wealth, limited stock market participation, lack of retirement planning, use of higher cost credit, being in credit arrears) are correlated with limited basic financial literacy, or advanced financial literacy (e.g., Alessie, Lusardi, Van Rooij, JFE; Disney and Gathergood, JBF 2013).

- Crucial problems:
  - potential for reverse causality or unobserved heterogeneity
    - search for an exogenous instrument
  - Optimal timing and duration of the intervention

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Problems with relying on financial advice

- Inderst and Ottaviani (2009): Conflicts of interest

- Hackethal, Haliassos, Jappelli (2012):
  - Poor matching between advisors and advisees
  - Being advised contributes negatively to outcomes
    - Advised sample had lower net returns and inferior Sharpe ratios, controlling for account-holder characteristics
    - Effects were stronger for bank advisors than for IFAs

- Bhattacharya et al. (2012):
  - Lack of willingness to get or accept advice
    - Only 5% willing to accept unbiased free advice
    - Those who did tended to be older, wealthier, more sophisticated

- Biases may prevent people from seeking advice
  - e.g., Overconfidence

(Bad) Influence of Social Interactions: Peer effects on household consumption and financial behavior

- Consumption: The Joneses just got richer and you haven't (Kuhn, Kooreman, Soetevent, Kapteyn, AER 2011)

- Consumption: The Joneses are poor, you look like them, and you spend on gold accessories to signal otherwise (Charles, Hurst, Roussanov, JPE 2009)

- Asset: The Joneses hold risky assets and you follow their example (Duflo and Saez, JPubE 2002; Kaustia and Knüpfer, JFE 2011)

- Asset: You bump into the Joneses a lot and you start investing in the stock market (Hong, Kubik and Stein, JF 2004)

- Debt: You perceive the Joneses as richer than you and you borrow, increasing risk of financial distress (Georgarakos, Haliassos, Pasini, RFS 2014)

On what basis to regulate?

- Product-based regulation
  - An FPA like the FDA?

- User-based regulation
  - Banning the unfamiliar?
  - or License to invest (different classes) and learner's permit?

- Practitioner regulation
  - Financial advisors providing advice and/or selling the product
    - Adequate background: e.g., pilot permits based on flying time
    - Disclosure of payment scheme and incentives
    - Separation of advising from selling function
      - Easier to incentivize advising to small customers?

  - Producers designing and marketing the product
    - Targeted transparency
    - Potential to monitor complexity???

Challenges with Product-based Access Regulation

- An FPA similar to FDA?

  - Very difficult to predict how a particular financial product will actually be used
    - Theory-based optimal use of an instrument does not reveal how it will actually be used
      - Securitization of mortgages and their breakdown into different risk classes that could be disseminated to those willing to take risks was theoretically sound
    - Seeing how an instrument was used in the past does not reveal how it will be used in the future
      - The precursors of asset-backed securities were German covered bonds, which effectively survived for 300 years or so
    - Seeing how an instrument is being used in one type of account is not informative on how it will be used in a different location (account), even by the same people (Bilias, Georgarakos, Haliassos, JMCB 2010)!

Inferring Potential Use from Use in Other Accounts: Stock Trading

- Finance: Discount Broker Accounts and Overtrading
  - Barber and Odean (*JF*, 2000): Discount broker data
    - Average household turns over 75% of its portfolio annually
    - Earns net stock portfolio returns substantially below market, because of transactions costs
  - Barber and Odean (*QJE,* 2001)
    - Men trade 45 percent more than women
    - Single men trade 67 percent more than single women, reducing their returns by 1.44 pp per year more than do single women.

- Economics: Retirement Accounts and Inactivity
  - Ameriks and Zeldes, 2001 (2004): TIAA-CREF data
    - TIAA-CREF administrative data on retirement portfolios of (mostly) academics in US institutions of higher education and research (1987-96):
    - In 10 years:
      - 47% of account holders made no change in flow allocations, 14% made only one.
      - 73% made no reallocation of accumulated funds, 14% made only one.

Is stock trading in brokerage accounts different?
Source: Bilias, Georgarakos, Haliassos (JMCB, 2010)

Period	Direct Stock ownership rates	Percent of Brokerage Account Owners	% Pop who traded stocks through a broker	Stock trading rates among brokerage account owners
1988-89	16.9%	**9.4%**	6.8%	**72.0%**
1991-92	17.0%	**12.5%**	8.6%	**69.0%**
1994-95	15.3%	**12.1%**	8.3%	**68.3%**
1997-98	19.2%	**15.5%**	11.8%	**76.2%**
2000-01	21.3%	**18.2%**	13.5%	**74.3%**
2003-04	20.7%	**15.8%**	10.4%	**65.4%**

Is stock overtrading, even in brokerage accounts, “lethal”?

Share of financial assets held in brokerage accounts

Source: Bilias, Georgarakos, Haliassos (JMCB, 2010)

Year	Mean Unconditional Share	Mean Conditional Share	Median Unconditional Share	Median Conditional Share
1989	0.028*	0.268*	0*	0.190*
1992	0.026	0.189	0	0.094
1995	0.020	0.154	0	0.025
1998	0.035	0.207	0	0.109
2001	0.037	0.190	0	0.094
2004	0.031	0.182	0	0.078
All	**0.03**	**0.194**	**0**	**0.093**

Challenges with user-based regulation

- Premise: households with certain characteristics or revealed behavior would over-expose themselves to specific products if allowed

- But:
  - Greater financial sophistication is not always associated with smaller losses Campbell, Calvet, Sodini (2007)

  - Fuchs-Schuendeln and Haliassos (2015): lack of familiarity does not seem to be a problem when the financial sector is itself familiar with the products and well-incentivized

Does product familiarity influence participation?
Fuchs-Schuendeln and Haliassos (2015)

- Large field 'experiment': German reunification
  - East Germans exogenously deprived of 'capitalist' financial products
  - Then, exogenously provided the same opportunity to use them as West
  - West German banks fully familiar with the products and well-incentivized
  - Presence of West German peers familiar with capitalist products

- Micro-data from the German Socioeconomic Panel (GSOEP): 1991-2009

- Results: controlling for characteristics, East Germans were
  - as likely to participate in securities as West Germans throughout the period
  - and more likely to participate in unfamiliar consumer credit.

- Thus, in the face of a knowledgeable and well-incentivized financial sector, the paper finds no evidence that lack of familiarity
  - discourages entry
  - or delays it
  - or encourages unwarranted entry (at least as indicated by subsequent exit)

- Results point in the direction of refocusing regulation:
  - Instead of a familiarity test (a la MIFID) for consumers,
  - regulation of the knowledge and practices of financial practitioners
  - A user license, possibly for different product classes?

Practitioner regulation: Financial Advisors

- Certification: do they know the material?
- License: Which products are they qualified to advise on/sell
  - "flight time"?
- Transparency: disclose incentive schemes
- Separate the advising from the sale function
  - Recall:
    - No Hippocratic oath
    - Under-developed legal framework of investor/borrower protection
- Access: non-rich clients?
  - With fee-only advisors, reaching out to the non-rich is probably encouraged

Practitioner regulation: Producers

- Transparency:
  - Not 180-page manuals!
  - User-specific, possibly using modern technology

- “Consult your advisor” nudge in financial product advertising

- Product “passport”: Provide range of outcomes: worst/best