Oxera

Agenda

Advancing economics in business

Regulating financial markets: what about the retail consumer?

The burgeoning market for financial services products can be bewildering for retail consumers. How can they be sure that they are making well-considered, objective decisions? Paul Koster, member of the board of the Netherlands Authority for Financial Markets, discusses the problems retail consumers face in making choices regarding their finances, and outlines initiatives to improve the decision-making process

Since the early 1990s, consumers have increasingly entered the stock markets, encouraged by rising property and stock prices and strong economic growth. The 1990s also saw the start of a trend towards a 'venture capital society', in which private individuals—to fund their pensions, for example—have to engage in supplementary financial transactions to provide for their old age. At the same time, the supply of a large and diverse range of financial products has boomed. These developments demand an increased level of knowledge and effort on the part of the consumer. Now taking greater risks with their money—but often without knowing the extent of those risks—consumers must take responsibility for their financial actions and need to recognise the importance of financial decisions. The question that arises is: can consumers manage these responsibilities, or do they need assistance? Furthermore, if they do need assistance, how can this be provided, and by whom?

The assumption that consumers behave like the theoretical *homo economicus*, making rational and conscious choices in order to maximise wealth, does not always hold true

Consumers as responsible market players

When analysing financial market structures and dynamics, an asymmetry in both the information level and the power between the supply side and the demand side becomes apparent: consumers are typically less informed and knowledgeable about products and services than suppliers. Also, individual retail consumers are not always in a strong bargaining position relative to banks and insurance companies, for example, due to a lack of information.

Furthermore, it appears that consumers are often incapable of making rational choices. The assumption that consumers behave like the theoretical *homo economicus*, making rational and conscious choices in order to maximise wealth, does not always hold true: in practice, consumers behave differently. Why is that? Specifically, how can it be that Dutch people, who are known to be penny-wise, are often pound-foolish?

Due to a lack of skills, some consumers cannot function optimally in the present knowledge-based economy. Research has shown that around one-third of adults are unable to distil correct information from a simple text or to draw the correct conclusions.[1]

On a different level, consumers allow their decision-making to be influenced by psychological and social factors. Just try and remember how you selected a bank, an insurance policy, a mortgage or an investment. The odds are that you were led, consciously or unconsciously, by ideas prevalent in your social circle or by your notions of right and wrong. Such factors play a part in all the choices you have to make in life, and together form the reference framework by which you classify, assess and evaluate matters. This framework restricts the selection process if you are looking for a good investment, for example, because the amount of information on which you base your choice remains limited.

Paul Koster is a member of the board of the Netherlands Authority for Financial Markets (Autoriteit Financiële Markten, AFM), which regulates financial markets in the Netherlands. The AFM regulates the behaviour of all participants in the savings, loans, investment and insurance markets.

The consequences of this pattern of decision-making are significant. The literature on this subject shows that consumers, among other things:

- are poor at assessing risks and opportunities;
- overestimate their ability to make choices and are overoptimistic about the results;
- take greater risks to avoid a loss than to make a profit, because, emotionally, losses weigh more heavily than equivalent profits;
- prefer investments offering a small chance of a large profit to investments offering a fair chance of smaller proceeds;
- are selective in using information, because they only see what they want to see;
- display a herd instinct and do certain things because ‘everyone does it’.

Thus, consumers of financial products and services enter a market in which they have less information than the sellers about increasingly complex products from which they must choose, and their frame of mind usually hinders them from making a rational choice.

Full protection is not possible in a free market where consumers are allowed to make any decision they want

Consumers should be able to make their own financial choices

It is clear that something should be done to try to achieve a well-functioning market. The question is: what objective should be pursued, and what should be achieved? Should consumers be protected, for instance, by policy-makers and/or regulators prescribing exactly what they should or should not do?

First, full protection is not possible in a free market where consumers are allowed to make any decision they want. Opting for allowing market forces to operate freely means that wrong decisions will be made, possibly with serious consequences.

Second, any form of protection (or strong guidance) diminishes the natural incentive for market participants to take their own responsibility. In economics, this is referred to as the problem of moral hazard. Perhaps this can best be illustrated by the view of experts that motorists tend to drive more recklessly when their cars are better equipped with safety options such as seatbelts and airbags, or when the motorist is driving a car that is not their property.

The objective should be to enable consumers to make choices and take responsibility, taking account of the following principles:

- consumers take responsibility for making well-considered decisions;
- where necessary, consumers avail themselves of competent assistance, but are also protected against risks that they could not have foreseen;
- financial services firms (or providers) should treat consumers with care.

Current initiatives: the Netherlands

The supply side

The Netherlands Authority for the Financial Markets (AFM) considers a whole range of solutions that may contribute to realising this objective. Some of these solutions are clearly in the hands of the government and regulators, but, importantly, many require the responsibility of ‘the market’. After all, a healthy, fair and reliable market in financial products is beneficial to everyone.

- *Transparency*—an important contribution concerns transparency of products. In the Dutch market, a standard information leaflet is compulsory for almost all financial products that have an investment component. Following a rigorous evaluation by the AFM, this document is adapted to increase its comprehensibility for consumers. An important new item is a graphical risk meter, which shows at a glance the level of investment risk associated with the product. This meter is comparable with the energy labels found on cars and refrigerators, for example.

- *Duty of care by suppliers and intermediaries*—the new information leaflet is part of a much wider package of measures resulting from the new Dutch Financial Services Act (2006). This Act places all financial intermediaries under supervision, which means in practice that everyone operating in this industry should have a licence. In order to obtain such a licence, intermediaries must fulfil a number of requirements. For example, directors should be reliable and staff members well trained. The commissions earned should be disclosed and arrangements about recommendations to clients should be well documented, including an assessment of the client’s propensity for risk. In other words, the Act focuses on the duty of care and transparency in the sales process.

  However, in the AFM’s view, it is not only the recommendations but also the products themselves that should fulfil the requirements, especially where the duty of care is concerned. After all, when developing their products, providers are already taking account of the target group they want to reach. Therefore, an organisation should incorporate the duty of care in the entire process, including the early design stage.

These measures are aimed primarily at providers and their supply of information to consumers. They seek to ensure that consumers are given the relevant information and appropriate treatment required to make an adequate decision.

The demand side

The AFM is also introducing a number of measures targeted at the demand side. These seek to make consumers more aware of their own behaviour and enable the exchange of information among consumers.

– *www.geldwaardering.nl*—one of the current AFM initiatives is an Internet forum for exchanging consumer experiences, both good and bad, of financial products. The AFM is currently working on a system similar in principle to that of the e-bay auction site, where buyers review sellers in order to alert other buyers to untrustworthy providers and other problems. This will help consumers learn from the experiences of others and may serve as an important alarm function for our regulatory activities. The new website was launched this spring.

– *A self-test*—the second measure for raising consumers' awareness of their own behaviour is the 'self-test', which enables consumers to take responsibility for their decisions in an interactive manner. The test is intended for consumers who are about to choose a particular product, such as a mortgage. By answering a number of questions, consumers will be led through the decision-making process and find out independently whether they are ready to select a particular product, or whether they need further advice or information in order to make the decision. Development of this test is in progress, and market participants are involved in the project.

– *Focus on independent information, research and education*—where financial products are concerned, many organisations in the Netherlands make great efforts in providing information to consumers or conducting research in that area. However, the AFM considers that all parties involved should step up the level of these activities.

  In this context, it would be more effective and cheaper to develop a comprehensive approach, rather than the fragmented initiatives we have at present. Such an approach might consist of, for example, a media campaign, better information provided from one central source, and coordinated education schemes in the area of financial products, in order to strengthen consumers' ability to make financial decisions.[2]

With the above initiatives and suggestions, we do not claim to have solved the issues the retail consumer faces, but we hope to be taking a step in the right direction.

Paul Koster

[1] Houtkoop, W. (1999), 'Basisvaardigheden in Nederland', Dutch research report.
[2] An example of this approach comes from the UK, where the lack of financial awareness among younger age groups is considered a particular concern. To address this problem, the Financial Services Authority (FSA) has recently published a seven-point programme, setting out how the National Strategy for Financial Capability will provide financial education, information and advice to schools, universities and colleges, the workplace and organisations that help young, and often excluded, adults. See FSA (2005), 'Urgent Need to Help the Young, says FSA', press release FSA/PN/029/2006, March 27th.