Ad Hoc Expert Meeting on Consumer Protection: The interface between competition and consumer policies

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Session 4: Emerging issues in consumer protection: Financial services

Presentation

by Phil Evans, United Kingdom

Emerging issues in consumer protection: Financial services

Phil Evans
Member; UK Competition Commission
Senior Consultant; Fipra International
Speaking in a personal capacity
phil.evans@fipra.com

Outline

- How do we understand consumer behaviour in markets?
- Where are the UN Guidelines on behaviour?
- Are financial services different?
- Are there any practical steps we can take?

How do we understand consumer behaviour in markets?

Traditional model

- The Consumer Black Box:
  - "All human behaviour can be viewed as involving participants who
    - maximise their utility (MAX-U)
    - from a stable set of preferences and
    - accumulate an optimum amount of information and other inputs in a variety of markets."

- Gary S. Becker. 1976. The Economic Approach to Human Behaviour

More recent models

- **Behavioural economics (BE): the 'we're only human' branch of economics**
- **Bounded rationality**:
  - human cognitive abilities are not infinite
  - we all have both limited computational skills and flawed memories;
- **Bounded willpower**:
  - humans often take actions in the short term that they know to be in conflict with their own long-term interests;
- **Bounded self-interest**:
  - people generally care, or act as if they care, about others, even strangers, in some circumstances.

- Christine Jolls , Cass R.Sunstein, and Richard Thaler. 1999. A Behavioural Approach to Law and Economics. University of Chicago Law School. Working Paper.

Prospect Theory can teach a lot

- Prospect theory (Tversky and Kahneman) has three general conclusions :
  - Context is key:
    - The structure of a problem may affect the choices that are made. The same problem presented in different ways may influence the decisions of participants.
  - Outcomes received with certainty are overweighted compared to outcomes that are uncertain.
  - Gains get treated differently to losses. Losses generate a risk seeking response while gains produce a risk averse response.

Why does this matter?

- HOW information is presented is centrally important
  - 'when a problem is presented in transparent form, choice behaviour **does not** violate basic tents of rationality. When choice problems are formulated in an opaque manner, however, people **may well** violate basic principles … because of the effect of 'framing' and so on.'
  - Tversky and Kahneman
- Are financial services products presented in a clear or opaque manner?
  - Are some products so complex that we move from bounds to rationality to barriers to rationality?
    - Peter Albin. 2000. Barriers and Bounds to Rationality.

Where are the UN Guidelines on behaviour?

UN Guidelines in context

General Principles:

- 3.(c) Access of consumers to **adequate information** to enable them to make **informed choices** according to individual wishes and needs;
- 22. Promotional marketing and sales practices should be guided by the principle of **fair treatment** of consumers and should meet legal requirements. This requires the provision of the **information necessary to enable consumers to take informed and independent decisions, as well as measures to ensure that the information provided is accurate**.
- 23. Governments should encourage all concerned to participate in the **free flow of accurate information** on all aspects of consumer products;

What model does the UN reflect?

- Information and information flows centrally important – part of fairness and empowerment
- Guidelines tend to be;
  - within traditional model of consumer behaviour
  - focused on TRANSPARENT information problems
  - focused on products rather than services (where sales process is more troublesome)
- Less focused on OPAQUE information problems;
  - Information seen as solution, not part of problem
  - Difficult to adapt to markets where HOW information is presented is the problem
  - Possible route through 'fair treatment'?

Are financial services different?

Thought experiment for FSA talk

- In UK financial services how do you maximise your utility (MAX-U); from a stable set of preferences and; accumulate an optimum amount of information and other inputs in a variety of markets.
- There are six core products that consumers 'need'
  - pension, mortgage, unit trust, investment trust, credit card and current account
- Assuming 30 minutes per product on offer (30,000!) in mid 1990s making a Max-U choice from stable set of preferences with optimal information:
  - c 4 yrs 5 mnths (40 hrs per week)
  - c 17 yrs 7 mnths (10 hrs per week)

Are financial services different?

- Making a ‘wrong choice’ is costly
  - Credit card fees, pension performance, mortgage arrears
- Discovering a mistake can take a long time
  - Understanding poor performance is not easy
  - Poor performing pensions – too late by time you find out!
- Product complexity is widespread
  - Complexity makes consumers
    - Exit market (401k example in US – increase choice/decrease choosers)
    - Choose on ‘proxy measures/choice editors’: ‘trusted brands’ - often worse performers
- Exiting market bad if poor financial provision – moral hazard
- Choice editors – need to focus on comparison sites and website ranking process – always ‘best results’?
- Proxy measures – incumbent bias – often worst performers
- Cumulative ‘wrong choices’ are dangerous – sub-prime lending

Are there any practical steps we can take?

Some possible behavioural economics rules of thumb?

- Information should be:
  - Clear: transparent as possible - mandate clarity (product design, licensing?)
  - Honest: independent as possible - role of consumer movement/regulators
- Consumers must be able to learn in markets :
  - Regular feedback: feedback loops have to be timely and accurate;
  - Cooling off: final decisions should be done away from sales
  - Revisiting: regular pressure-free re-evaluations should be available
- Minimise consumer costs
  - Stop momentum/overconfidence: sunk costs should be avoided
  - Search costs: should not be artificially increased
  - Complexity: should be minimised by regulators
- Do we opt for Paternalistic libertarianism, nudging decisions or license products/ringfence basic products to anchor market?

Conclusions

- Better understanding consumers requires we revisit any rules based on traditional models
- Does not require complete change:
  - in transparent markets consumers tend to conform to traditional models
- BUT in opaque markets may not be fit for purpose - information (and how it is presented) can be the problem not the solution!
- Financial services is an opaque and complex market
- Consumers often choose badly with big consequences
- May have moved from bounds to barriers in rationality (i.e just can’t choose properly) – who erected those barriers?
- Need to revisit basic product design/performance issues – do we have parallels? (medicine? product safety?)
- How far can ‘fair treatment’ take us?
- Do we need to understand firm behaviour/decision making better?