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

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Emerging issues in consumer protection: Financial services

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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.”

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.

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 mths (40 hrs per week)
  • c 17 yrs 7 mths (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?