ECRI 10TH ANNIVERSARY CONFERENCE

THE FUTURE OF RETAIL BANKING IN EUROPE: COMPETITION AND REGULATORY CHALLENGES

Minutes

European Credit Research Institute at the Centre for European Policy Studies
10 June 2009, 9:30-12:30, Place du Congrès 1, B-1000 Brussels

Event jointly organised with

The current financial crisis has triggered massive state interventions and large-scale regulatory initiatives affecting Europe's banking industry. While most of the discussion has focused so far on the banking market as a whole, participants at this high-level conference, organised jointly by the European Credit Research Institute in Brussels and the DIW Berlin, will discuss how the turmoil affects the retail side of the financial services market. A special focus will be placed on the impact it has on competition and regulation.

Will state aid, such as bailouts, subsidies or guarantees undermine market discipline and change the risk/return calculations of banks? Are these capital injections in fact used to maintain an adequate level of lending to companies and households, as demanded by the European Commission? Further, will the shift of focus of some major banks from investment to retail banking lead to more aggressive commercial behaviour in the latter segment? Another question requiring discussion is how the industrial organisation is changing as a result of the ongoing emergency mergers.

It ought to be ensured that today's solutions do not (again) become tomorrow's problems. We should not create financial conglomerates that are too deeply embedded in the economy due to outreach in many upstream and downstream markets to be allowed to fail. What role should competition policy play in this context exactly? Another major set of questions to be discussed is what kind of regulatory framework would mitigate against increased endogenous risks, and how can market failures that occur through a misalignment of incentives be prevented?

This conference brings together leading academics and policy-makers to discuss the latest insights to emerge from research on competition and the regulation of retail banking in Europe.

More information can be found at: www.ecri.eu.

Daniel Gros, Director of the Centre for European Policy Studies (CEPS) opened the event and welcomed all participants to the Anniversary Conference. He introduced the audience to the European Credit Research Institute, which has provided research on credit markets and regulatory challenges since 1999. He stressed that in times of the current financial crisis, research on the macroeconomic problems of indebtedness is very important.

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Professor Christian Wey, DIW Berlin and Technische Universität Berlin, chaired the event and welcomed all participants on behalf of ECRI and the DIW Berlin. In his introductory remarks, Mr Wey outlined the importance of the issue of retail banking in Europe, especially in the context of the ongoing financial crisis. New regulatory measures are being discussed by governments that might have tremendous consequences for competition and the retail banking landscape.

The first panel discussion, entitled "Challenges for competition policy in European retail banking" was opened by **Professor Georges Siotis**, member of the Chief Economist's Team at DG Competition, European Commission, who explained the diverse objectives of competition enforcement at national and European level. Since markets are not always efficient, certain state measures are intended to address market failures, such as systemic effects or crises of confidence. Nevertheless, there is also the risk that state measures may distort competition. State aid and other bailout plans may create situations of moral hazard, because banks know that part of their risk is taken over by the national state. Additionally, the cost structures of markets are affected, which again may distort competition. Therefore, it is important to make sure that the provision of state aid does not open the way for a new crisis.

As regards the role of the Commission, **Mr Siotis** listed the various measures that have been adopted in the past by DG Competition in order to deal with the crisis, covering ex-ante guidance, decisions on cases and on schemes. The Commission's first Banking communication in October 2008 established general principles of non-discrimination and pricing of guarantees, which basically followed the recommendations of the European Central Bank (ECB). Following the member states' increasing recapitalisation activity, the EC published another communication in December 2008 to establish the distinction between fundamentally sound and unsound banks and to provide pricing recommendations according to banks' risk profiles. The impaired asset guidance of February 2009 addresses the problem of banks having toxic assets on their books, which appears to be a widespread problem across Europe. A fourth communication is forthcoming that will explain how the Commission is applying recapitalisation criteria and other guidelines. A possible common European stress-test would be based on the same standards across all legislations and could be carried out by the Committee of European Banking Supervisors.

Regarding state aid for the financial sector, the EC has to date decided on 57 individual cases and an additional six cases are being investigated. **Mr Siotis** expressed his concern about the future scenario, once schemes come to an end. In terms of schemes, the Commission has approved guarantee, recapitalisation and liquidity measures. For member states' guarantee schemes, the amounts that have been drawn on by banks increased significantly: while the percentage of claimed funds used to be around 10-15% of the total that could potentially be covered, this number increased to 32% over the past few weeks. **Mr Siotis** pointed out that those schemes were adopted over a short period of time and are not flawless. Given the size of the problem, the question arises as to whether there should be one specific scheme to deal with banks in distress. For the future, it would be desirable to have a more widespread use of schemes, possibly similar across member states, in order to avoid the difficult choice between a fully-fledged taxpayer financed bailout and bankruptcy of the Lehman-type with all the disruptive effects involved.

In the second presentation, **Professor Giancarlo Spagnolo**, Università di Roma "Tor Vergata", Stockholm Institute of Transition Economics and Einaudi Institute for Economics and Finance, focused on the implications that the crisis could have for competition policy in the retail banking sector. Just before the crisis broke out, competition policy in the banking sector

had received much attention, with conferences being held at international institutions and sector inquiries carried out by competition authorities. The break-out of the crisis then led to a decline in interest in competition policy and a refocusing on stability and safety concerns.

Mr Spagnolo stated that financial services have always been considered a 'special industry' with regard to the trade-off between competition and stability and in terms of the public good it provides. When estimating possible developments in financial markets in the future, the first problem is that the exact causes of the crisis have not been fully identified. Several factors played a role in his view, possibly bad corporate finance, regulatory failures and lack of understanding of financial innovation, but not competition policy. From the competition policy point of view, however, the unfortunate coincidence was that competition rules were applied more and more to the banking sector just before the crisis. The question is then whether the evidence to prove that competition policy has had a good effect in banking is sufficiently robust to counter-attacks, and more generally what evidence we have on the effects of such policy.

Mr Spagnolo presented a recent research (Buccirossi et al. 2009) studying the link between competition policy and efficiency growth measured through the growth of Total Factor Productivity.[1] Thirteen jurisdictions and a large number of industrial sectors were included in the analysis, and the result was that competition policy appears to exert a significant and positive impact on total factor productivity in a large number of sectors, particularly when coupled with a high quality of law enforcement institutions.

Mr Spagnolo then presented results of an ongoing study with E. Carletti (EUI) and S. Ongena (Tilburg) showing that the switch of authority on merger control in Banking from Central Banks – traditionally more concerned with stability – to Competition Authorities, more concerned with competition, seems to have a) increased bidding competition during mergers, b) created value increasing the number of national and – particularly – cross-border mergers, and c) selected less-anti-competitive bank mergers on average.

In his concluding remarks, **Mr Spagnolo** emphasised that in many recent retail banking inquiries undertaken by Competition Authorities, simply the prices of bank products have been surveyed, without adjusting such measures for their different levels of risk. In order to face future attacks, Competition Authorities should improve their methodology, always including 'risk', which represents the main quality dimension in financial markets.

In the third presentation, **Professor Hans Degryse,** CentER/Tilburg University, discussed the current financial crisis and competition in retail banking based on insights from the latest academic research. Financial intermediation is an important determinant of economic growth, since banks reduce problems inherent in financial markets. At the moment, one important question concerns the right structure that would allow for a quick recovery of financial markets from the financial crisis.

Two methods evolved over time for the discussion of competition in retail banking: the traditional industrial organisation (IO) approach with approaches such as structure-conduct-performance (SCP), and concepts such as bank efficiency, economies of scale and scope; and the new empirical IO. The SCP paradigm shows that higher concentration may cause less competitive conduct and increases banks' profit. Loan rates mostly increase with the concentration index. New empirical IO focuses on structural models, statistics and takes

[1] For details on studies, the interested reader is referred to ECRI's website (www.ecri.eu), where the presentations are available.

endogeneity into account. For instance, the Panzar and Rosse-statistics allow for cross-country regression and consider the sensitivity of revenues with respect to input prices.

Mr Degryse pointed out that the relation between competition and stability is endogenous. Empirical work on that topic is mainly inconclusive, because there are different ways of measuring competition. Another problem with competition analyses is that they are mostly applied during normal periods; estimations in stress periods are therefore difficult. Recent work has shown that banks apply lower lending standards and screen less when the economy is booming, since all projects seem profitable. Competition makes this effect even stronger, because the incentive to screen is lower. During the subprime boom, lending standards dropped dramatically and maybe now standards are back at the right level, he stated.

Regulation has also a significant effect on market presence. Studies have shown that there are important differences between foreign entry restrictions and government ownership across countries. Foreign entry is mostly associated with positive effects, while state ownership leads to less competition and slower innovation. This topic is of interest, governments' engagement is growing and politicians are increasingly getting involved in banks' decisions. **Mr Degryse** mentioned that there is a risk that poorly managed banks may lead to the next crisis, so this topic needs special attention.

Professor Roman Inderst, Johann Wolfgang Goethe-Universität Frankfurt am Main, opened the second panel on "Lessons for regulatory initiatives in retail banking" addressing issues of regulation and consumer protection in retail banking. For the minutes of his speech, please see the transcript in Annex 1.

In his speech, **Damien Gerard**, Research Fellow at the Chair of European Law, Université Catholique de Louvain, addressed the "impact of the conditionality of bailout plans on credit institutions". The EU framework has been dominated by national bailout plans and European coordination and guidance. At EU level, two main policy objectives have been pursued, namely: (i) preventing distortions of the internal market by ensuring compliance with the principles of non-discrimination towards foreign banks and proportionality of state support; and (ii) keeping adequate incentive structures to avoid excessive risk-taking.

To prevent distortions of the internal market, the Commission has conditioned the authorization of bailout plans on various requirements, including behavioural constraints, for instance on advertisement of the benefit of state guarantees, and structural measures, such as reductions or pullout of activities.

Moral hazard issues have been addressed, e.g., by means of limitations on the eligibility of debt instruments for state guarantees, on the distribution of dividends and on remunerations or packages of executives. However, the schemes put in place to limit moral hazard issues vary widely across member states.

The central points in **Mr Gerard's** final remarks included the challenge of designing policy guidelines to deal with the crisis as well as the question of whether structural compensations are desirable. Further, he highlighted the potential tensions that could arise with internal market policy, and finally the possible convergence of competition and regulatory objectives.

In the last presentation of the day, **Eric Ducoulombier**, Deputy Head of Unit "Retail issues, consumer policy and payment systems", DG Market at the European Commission addressed the regulatory challenges of retail banking. The integration of retail financial services has been one

of the priorities, as stated in the Single Market Review at the end of 2007. However, the crisis has had an impact on the Commission's short-term priorities and more urgent concerns have pushed the integration of retail banking off the top rung of the political programme. Nevertheless, the long-term objective of integration remains the same and initiatives are still ongoing, such as on the mobility of bank accounts, on redress, on mortgage credit issues etc. Some projects have been somewhat refocused. For example, the integration of mortgage credit markets, a topic that the Commission had been working on for more than five years. With the crisis, the focus on mortgage credit has been evolving from a purely market integration approach to the idea of responsible lending and borrowing. Such reorientation is understandable, since irresponsible lending is at the very source of the ongoing crisis.

The Commission has initiated a reflection on whether the irresponsible lending that took place in the US could occur in Europe as well. It appears that there are already some safeguards in place in the EU (thanks in particular to the consumer credit directive). Yet, national standards differ across countries, in particular in the un-harmonised area of mortgage credit. Some issues that are relevant for responsible lending and borrowing are: information provision, possible obligation to provide advice, access to credit data within a country and across borders, self-certification of creditors, credit intermediaries and remuneration systems, as well as non-bank credit providers that are not regulated by banking legislation. The Commission will launch a written consultation on responsible lending soon, with a public hearing taking place on 3 September 2009.

In his concluding remarks, **Mr Ducoulombier** stated that the banking markets will benefit from the initiatives taken by the Commission, the Parliament and Council to restore normal market conditions and to improve prudential supervision. The main challenges and questions faced by any future retail initiative are: How to pursue the integration of retail markets against an adverse political and economic climate? How to convince stakeholders to continue on the same path of retail banking integration, when the success of market integration has been so far limited? For the integration of retail markets, **Mr Ducoulombier** emphasised that confidence is crucial for any further development in the financial services area.

Closing the workshop, **Mr Wey** summarised the speakers' main points. The key message being that competition policy in retail banking faces major challenges in the upcoming years. The financial crisis has had a significant impact on reflections about competition and has even temporarily knocked the discussion on competition policy in retail banking off the top priority list of policy-makers, as more urgent matters have emerged. Short-run aims may have changed, but objectives remain the same in the long-run. Regarding the activities of supervisory authorities, it appears to be desirable to adopt a more flexible case-by-case approach instead of standard measures.

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Retail Finance: Rethinking Regulation and Consumer Protection in the Shadow of the Financial Crisis

Roman Inderst, University of Frankfurt (IMFS)

1. Baseline Remarks

At least from the beginning of 2007, the growing problems in the US subprime market became evident. This has focused international attention on the area of retail finance – an area that typically receives much less attention than the fancier world of wholesale finance and investment banking. As the crisis deepened, however, attention quickly shifted back towards the wholesale end, such as the markets for asset-backed securities and credit default swaps. Only occasionally did the retail side of the crisis resurface, for instance when it came to protecting banks' retail deposits.

Still, the present crisis provides an opportunity to carefully rethink existing legislature and regulation that govern the delivery of financial products to households, both on the "asset side" of their balance sheet, such as savings and investment, and on the "liability side", such as consumer credit and mortgages. Such a rethinking provides the chance to build future legislation as well as supervision on sound economic principles. Only then can we hope to create a consistent body of legislative and regulatory work that serves the people of Europe.

To rethink the principles of consumer protection more generally is also overdue in the light of past as well as ongoing initiatives of the European Commission. I do not have the time to comment in detail on this activity. Clearly, on a general level the consumer directive represents a cornerstone. More specifically, with MiFID much progress has been made in the area of financial instruments, including retail finance. But how do these various directives fit together, say when it comes to the different treatment of insurance products that have a savings and investment character and retail financial products?

Other proposals and activities underline even more the need to rethink policies from first principles. Take the case of the initiative to harmonize across countries the law governing early-repayment clauses for mortgages. Presumably, one side effect of such a harmonization may have been the creation of a European market for mortgages and mortgage-related products. I guess that presently there is little political appetite to support such a project. However, the idea to impose a minimum statutory repayment right, which mortgage takers would not be able to wave, has also received support based on the notion of consumer protection.

European countries exhibit a baffling diversity in how households finance their mortgages, varying in their use of fixed versus variable interest rates or the amount of debt in relation to a property's value. Housing market conditions as well as national law may explain some of the differences. Also the use of prepayment clauses or lock-in clauses vary widely. An understanding of what drives these national differences is clearly a necessary first step before drafting a plan to harmonize existing laws or even imposing contractual uniformity across Europe.

In this talk, I will, however, comment briefly on a different policy instrument: Disclosure of conflicts of interest and thus, in particular, of commissions and “kickbacks” that financial intermediaries or advisors receive. Such a requirement is part of MiFID, though it remains to be seen to what extent member states and their national agencies, as well as courts, enforce compliance. But I will also talk about contractual lock-ins and the potential role of statutory provisions for early cancellation. What will tie these two topics together is that in both cases my focus will be the role of financial advice.

I will conclude my talk with some remarks on competition and innovation. There and also in the preceding remarks, I will repeatedly stress one and the same view: That viable competition, when governed by an adequate set of rules, is the best recipe for the protection of almost all consumers, generally and also with respect to financial and insurance products. That being said, this leaves ample scope for an active consumer protection policy that sets rules and sanctions misbehavior.

2. Putting Consumer Protection and Regulation in Retail Banking on a Sound Basis

Households’ financial decisions have increasingly attracted the attention of academics. Key drivers of this increased interest are profound changes to households’ personal balance sheets: They became longer, as homes substantially increased in value; on the asset side, expected payouts from pay-as-you-go pension schemes were replaced by contributions to pillar II or pillar III pension schemes; and on the liability side, we witnessed, at least in some countries, a massive increase in secured and unsecured debt.

The academic literature, most notably the large literature on household finance, has almost completely ignored the role of the supply side. But for retail finance this is key. Retail financial and insurance products are often “not bought but sold”: The initiative is taken by a broker or a client’s relationship banker. Moreover, with the exception of the most sophisticated investors or those brave or unknowing enough to take bets with online brokers, retail financial investors also rely on advice.

2.1 Mapping the Trilateral Agency Problem with Financial Advice

In countries like the UK, independent financial advisors play a key role. They may either advise customers on a fee base, or more often earn profits through more or less hidden commissions and product-based charges that reduce yield.

Irrespective of whether products are sold through a firm’s integrated channel, as in the case of many retail banks, or whether sales rely on third parties, as is often the case with insurance, a trilateral agency problem arises: between the customer, the agent or employee, and the product provider. What is more, the respective agent, be it an insurance broker or a financial advisor, may undertake multiple tasks. These tasks may include searching for customers, getting acquainted with new products, getting to know a customer’s personal circumstances, and finally providing advice and concluding a sale.

Commissions paid to these agents thus have multiple roles to perform. Policy intervention that will stifle commissions or impact on their form may have beneficial implications along one task, say to reduce the bias of advice, but they may generate unintended consequences along other tasks, resulting ultimately in a reduction of social efficiency.

In a string of recent work, most with Marco Ottaviani from Kellogg, I have looked into the multiple functions that commissions play and the impact of policy intervention. Take the case of a mandatory disclosure of commissions.

When customers do not hold appropriate expectations about the level of commissions, the market will clearly malfunction, as they underestimate the prevailing conflict of interest. Take one example outside the area of retail finance: As work in the UK on doorstep selling has shown, the margins earned by sellers are sometimes incredibly high, given that the targeted customers seem to be reluctant shoppers. This explains sometimes stupendously high commissions and thus obviously high incentives to coax customers into a purchase. There, a case for disclosing commissions to unknowing or even naïve customers is clearly warranted.

Our research shows, however, that mandatory disclosure can be socially harmful by stifling the roll-out of more efficient products. While reducing bias in advice, such disclosure may also stifle the acquisition of information by advisors. Overall, this may imply that the quality of advice deteriorates.

Our research also sheds light on when we should expect problems of unsuitable advice and misselling to be more pervasive, and when not. When product providers' own agency problems with their employees or, likewise, with independent advisors or an independent sales force become more severe, misselling is more likely. Competition can also be inducive to problems of misselling, as fiercer competition among agents forces firms to restructure their commissions more aggressively. Furthermore, consumers may still benefit. When consumers are more complacent, more of the burden of being vigilant shifts to supervision.

Furthermore, when advisors earn their profits only through an hourly fee and no longer through commissions based on subsequent sales, biased advice becomes clearly a lesser concern. But the overall quality of advice and thus of households' investment or credit decisions may still suffer when regulation intervenes by favoring a particular way of paying for advice. Earning a commission on a subsequent sale may be necessary to provide an agent with sufficient incentives to really exert effort and provide valuable advice. This is the subject of ongoing research.

Without understanding the economics of advice, any interference in the market is doomed to generate unintended consequences. Clearly, not every effect that a theoretical model generates is of first-order importance in a particular market. This is where institutional knowledge, as well as empirical analysis, must meet up with sound economic theory.

Based on an large grant from the European Research Council, we are presently building up a center for the research on the regulation of retail finance at the Institute of Financial Stability in Frankfurt. This will be in close cooperation with other European universities and legal scholars. The issue of consumer protection is here at the core.

2.2 Principles of Consumer Protection

With great simplification, two views of consumer protection seem to exist. One view holds that consumers must be protected from other parties, that is firms' possibly hazardous products or, say, misleading advertising and aggressive sales strategies.

The other view holds that consumers must be protected from themselves: Even when given full information, a wide range of products and services, as well as access to valuable advice, consumers will make choices that are, so the argument goes, not in their own long-term interest.

Arguably, the complexity of many financial products poses a substantial challenges to consumers. This holds, in particular, for countries where financial literacy is low and where households have not gained long-term experience with making financial decisions.

The area of household finance has made advances in documenting and explaining household portfolio choice. Research on this frontier is driven by puzzles, such as low stock market participation, underdiversification or, on the credit side, the sluggish refinancing behavior of mortgage holders.[1] Literature on behavioral finance documents further "biases", at least among some investors, such as overconfidence.[2]

Policy makers should be warned to draw too strong conclusions from the existing academic literature. Many studies are based on experiments – and there is substantive doubt also on the interpretation of these results. With regards to field studies, it must be born in mind that the results may be very sensitive to the particular country and, therefore, the social and cultural background of the respective customers. For instance, an influential strand of the literature presumes that the typical consumer procrastinates.

Proponents of this view then suggest that consumers are ill-serviced by credit products that tempt them, say through low teaser rates, to consume more and save less than what is actually best for them. Indeed, the assumption of such procrastinating behavior is often justified by households' low savings rate. Needless to say that this is view based on observations from the US and not from, say, Germany with a much higher savings rate.

Clearly, with retail financial products there is much scope for firms to misrepresent information, say on costs or risk, and there is much scope for households to misinterpret information. To the extent that the industry collectively fails to develop and adhere to sufficiently high standards, policy intervention is called for, in the interest of both consumers and firms with a long-term view.

That being said, in my view the key principle of consumer protection with retail financial products should still be to protect consumers from misbehaving firms, and not so much from their own biases or follies. And even then the first reaction of an economist should still be to ask why does the market not provide a solution without intervention.

Take the case of, to use here a general term, mandatory minimum cancellation rights. This seems particularly relevant with respect to savings and investment products that are wrapped into insurance products. Such cancellation rights protect consumers when buying without perfect information about their preferences, for instance, as they will learn over time.

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[1] E.g., Campbell (2006).
[2] E.g., Odean (1999).

As I explore in current research, cancellation rights also protect rational customers from being ill-advised by sellers who, in particular with complex products, may possess superior information at the time of a purchase. Generous cancellation rights then make unsuitable advice more costly for the seller. Or, put into economic lingo, they make "cheap talk hard".

But with wary, rational consumers there is no need for policy intervention. Firms have every incentive to offer the so-called second-best efficient contractual terms, given that through higher prices they can extract any additional value that is created by commitment to better advice. However, as we show, policy intervention is warranted when some consumers are excessively credulous in that they do not see through a seller's strategic talk and are blind to the conflict of interest.

Interestingly, we show that a minimum statutory right of cancellation may then be effective even when it is not binding, given that many or even all firms offer more generous terms. This is the case as such a minimum statutory right makes it relatively less profitable for firms to target only credulous consumers compared to targeting all consumers. But when firms cater to both wary and credulous consumers, then the former essentially take care of their less sophisticated fellow consumers. Our research also suggests that a different regulatory approach may be appropriate for different sales channels.

4. Competition and Innovation

Competition is the most powerful ally of consumers. And, in contrast to some often made claims, there is also no clear-cut trade-off between financial stability and competition.

Admittedly, a long tradition in the theory of banking argues that more competition leads to more risk taking and thus higher default risk, which brings us back to the present financial crisis. More recent work qualifies this view, however, both theoretically and empirically.[3] Moreover, in cases where such a negative trade-off between competition and stability exists, policy and supervision are first blame: either because regulation and government intervention created exploitable situations in the first place; or because supervision did not react flexibly enough.

The present financial crisis can not be seen as a verdict on the superiority of government intervention and regulation compared to market forces. To the contrary: Government interference in the subprime market created the seeds of destruction and at least in some countries, such as Germany, it were, in particular, banks with politicians on their boards, such as the Landesbanken, who took the worst gambles.

Regulation and supervision has failed by shying away from addressing the problems early enough: The large exposition of banks to ever more complex off-balance sheet risk was not an "unknown unknown", but a "known unknown". Supervisors failed to be proactive. Regulatory capture may have been one reason for this.

In the remaining time, I will preach the virtues of the market. In some European countries there is clearly the risk that the present financial crisis will stifle market forces for a long time. The two main forces are industry consolidation where there is already high concentration and, as I fear, regulation and supervision that frame vigorous competition and the development of new business models as "systemic risk factors" that need to be subdued.

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[3] On the theoretical side, see Inderst et al. (2008). On the empirical side, see Boyd et al. (2006).

A case in place is clearly the tie-up between HBOS and Lloyds'. HBOS is the UK's biggest mortgage lender, writing one in five of all new home loans, while Lloyds' is the third biggest lender overall. The two groups may end up having a combined mortgage book of, at first count, three times the size of the next biggest rival, Nationwide. HBOS is also the biggest savings provider, while Lloyds' is the third largest. Recent inquiries into the UK's banking market, as well as decisions by the UK's Competition Commission, all shared one view: Further consolidation should not be permitted, even under wide-ranging remedies.[4]

3.1 Too much innovation?

I view competition as a main force to generate innovations. While central bankers may wish for more "boredom", as expressed by the UK's governor, even in the case of finance and banking I regard innovations as something that must be fostered and not as something that needs to be stifled.

Even without talking about "weapons of mass destruction" in the disguise of new financial products, one could agree with Miller (1986): "The major impulses to successful innovations over the past 20 years have come, I am saddened to have to say, from regulation and taxes". Still, financial innovations arguably complete the market, address agency concerns and information asymmetries, minimize transaction costs, or respond to new risk factors or new technological developments.[5] There are abundant examples in retail finance, including the distribution of exchange-traded funds, the introduction of internet banking, or process innovations such as credit scoring.[6]

Often, shifts are more gradual, as in the case of mortgages. A key part of the innovative process is that firms experiment with the marketing of well-known products.[7] But this shall not suggest that every newly introduced contract was to the benefits of customers.[8]

For instance, "endowment" or "savings and equity" mortgages may offer tax advantages to some households. But other households may have simply underestimated the risk of the bundled-in equity-investment plan.

Still, there may still be plenty of scope for beneficial innovations. For instance, a roll-out of fairly-priced reverse mortgages could potentially benefit many aging households.[9] Also, the further development of credit scoring will continue to reduce transaction costs and to facilitate entry into local markets, bringing down interest rates and broadening access to loans.[10] For the

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[4] The Cruickshank report in 2000 urged the government to put a stop on the further consolidation of the industry. The Competition Commission stopped, for instance, the proposed merger of Lloyds and Abbey National.

[5] See Tufano (2002) or Merton (1992) for a more detailed discussion.

[6] E.g., Frame and White (2002).

[7] A consequence is that shifts across countries are not homogeneous. For instance, fixed-rate contracts have picked up in some European countries, as in the UK, while variable-rate contracts have become more common in others, as in Denmark. See Miles and Pillonca (2007).

[8] E.g., Scanion and Whitehead (2004).

[9] Furthermore, in the absence of inflation indexing, once inflation picks up, many mortgages may have an excessively skewed repayment profile, in terms of "front end loading".E.g., Campbell and Cocco (2003).

[10] DeYoung et al. (2008), for instance, document this for small business lending, where the form of borrowing is similar to that of unsecured household loans.

US, various studies indeed find that the market for borrowing has become more perfect, as measured by reduced volatility of consumer spending or a closer alignment of consumption and long-term income prospects.[11]

But who are the main innovators? While this is a key theme in Industrial Organization, the literature on retail finance is thin. Earlier studies suggest that size is important, in particular for the introduction and roll-out of new services.[12] More recent studies suggest, however, that smaller firms are more innovative.[13] According to a recent study that exploits articles from the business press, the by far most innovative firm in the US was Merrill Lynch.

This brings to mind the following well-known story. (In-)famously, in 1977, it was also Merrill Lynch that invented the Cash Management Account, in effect allowing non-banks to circumvent the equally infamous Regulation-Q. As some will know, this regulation capped deposit rates and forebade banks from paying interest on checking deposits. The market's innovations forced regulators to phase-out Regulation Q and to override state usury ceilings.[14] The benefits that this innovation brought to ordinary savers should be obvious.

4. Concluding Remarks

The present crisis provides an opportunity to rethink consumer protection in the area of retail finance. Consumer protection policy can and must be put on a sound economic basis, though surely enriched with insights from other disciplines such as psychology. I also have emphasized that vigorous competition should be seen as a key ally to consumer protection. That is not meant to say that competition policy is an adequate substitute for consumer protection policy. Healthy competition relies on a set of rules that constrain firms' opportunistic behavior, irrespective of whether these rules are self-imposed by industry standards or through policy intervention.

I would hope that there will be as much progress of good economics in the area of consumer protection as there has been over the last decades in the area of competition policy. This does not only apply to academics, but more importantly to the policy practiced by the relevant agencies, most notably the European Commission. By setting high standards of good economic practice, both in terms of valid and consistent arguments and in terms of empirical evidence, the European Commission's competition policy has recently provided a valuable motivating and disciplining force for national agencies in Europe. What is more, in the area of competition policy the process of drafting new rules and guidelines is by now heavily influenced by sound academics. I would hope that a similar direction will be taken in the area of consumer protection in financial services, again with a leading role taken by the European institutions.

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[11] E.g., Gerardi et al. (2007) or Dynan et al. (2006).
[12] E.g., Frame and Wright (2002) and Tufano (2002).
[13] See Lerner (2007).
[14] E.g., Gilbert (1986) and Cocheo (2003).

Selected Literature

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