Consumer Protection and Financial Markets: the 'Cinderella' Problem

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Consumer Protection and the Financial Markets: New Thinking?

- Financial Market Consumer Protection: the "Cinderella" of Financial Market Regulation
- The Financial Crisis
  - The "panicked mass public" (Ramsay)
  - Too big to fail – or too many to fail? (Zingales)
  - An "adventure in financial innovation" needed/democratization of markets (Shiller)
  - Suboptimal engagement by households in financial markets (Campbell)
  - **But:** did the crisis prompt new ways of addressing old and intractable retail markets problems? Compare wholesale market regulation? International dynamic?
  - Retail markets downstream in the crisis-era reform movement
    - Ex: EU experience

Consumer Protection and the Financial Markets: New Thinking?

- What is at stake?
- (1) Traditional investor protection?
  - Persistent market failures arising from information asymmetries
  - Exacerbated by agency risks + behavioural vulnerabilities
  - Risks generated through range of distribution channels + product designs + related incentive risks
  - Response:
    - Initially: disclosure
    - Modern approach: interventionist
      - Disclosure + distribution + now product governance/regulation

Consumer Protection and the Financial Markets: New Thinking?

- (2) More recently, empowerment/engagement?
  - The household finance problem and 'financialization'
  - The 'financial citizen' making informed choices and taking on welfare burdens from the state
  - Response: disclosure + product choice + access to advice channels
- → Protecting/supporting the engaged "[…….]"
  - A **prudent 'consumer'** of standardized/commoditized investment products, addressing welfare needs.
  - Or a **speculative 'retail investor,'** deploying discretionary funds and using market techniques (diversification/hedging) to supply capital?

Consumer Protection and the Financial Markets: New Thinking?

- Trends in Scholarship?
  - A shifting/unstable focus…..
  - Law and economics: principal/agent risks
  - Law and finance (functionalism): what works?
  - Empirical dimension strengthening
    - Behavioural finance
  - Household engagement problem
    - Financial economists
- Why it matters…

The Regulatory Design Challenge

- Longstanding risks
  - Disclosure failures; product complexity; conflict of interests (mis-selling); competence problems
  - + Disengagement from financial markets
- Longstanding tools
  - Disclosure + product distribution
  - Limitations clear from multiple empirical studies/litigation/large-scale mis-selling episodes
- Limited ability of consumer to self-protect
  - → Pressure on regulator
- But: limited attention span of regulators
  - Capital Markets Union and the retail interest….
- Lack of pressure from international governance
  - Financial Stability Board; IOSCO? Peer reviews…..
- Lack of momentum from great reforming movements

The EU Response: A Brave New World?

- EU typical of recent evolution of consumer protection in financial markets
  - The long dominance of disclosure + distribution
- But: some evidence now of new thinking
  - Arrival of product regulation/governance with MiFID II
  - Focus on consumer protection + on supporting outcomes.
  - Less empowerment: regulation engaging in the "heavy lifting"
  - But:
    - Unresolved tensions with Capital Markets Union and the consumer as supplier of capital
    - Commission, Green Paper on Retail Financial Services (COM (2015) 630)shades of empowerment/liberalization?

The EU Response: A Brave New World?

- 2014 MiFID II/MiFIR: reshaping of the regulatory space
  - (1) Product Governance/Oversight
    - MiFID II A 9
      - Board to define, approve, and oversee policy on products offered; in accordance with characteristics/needs of clients + stress testing
    - MiFID II A 16(3)
      - Firm which 'manufactures' financial instruments for sale must maintain, operate, and review a process for approval
      - ***Design*** elements (target market – relevant risks to market identified); ***distribution*** elements (strategy consistent with target market); ***disclosure*** elements
      - Review of products (instrument remains consistent with needs of target market)
      - Information (including target market) available to distributors

A Brave New World?

- MiFID II A 24(2)
  - Instruments manufactured must meet needs of an identified target market; compatible distribution

- (2) Product Intervention
  - MiFIR: European Securities and Markets Authority/European Banking Authority and national competent authorities/supervisors intervention powers

A Brave New World?

- European Supervisory Authorities and soft Guidelines
  - Joint ESA Manufacturers' Product Oversight and Governance Process Guidelines/Joint Position (2013)
  - ESMA Guidelines on Structured Product Governance (2014)

Threshold Question (1)

- Product regulation is a potentially powerful new tool in the EU toolbox
  - Weaknesses of disclosure (investor/consumer capacity) + distribution (conflict of interest risks)
- But threshold questions arise, as for any new approach, in designing the new regime
- **(1) What is the purpose of EU intervention?**

Threshold Question (1)

- EU evolution stage 1 (→ late 1990s)
  - Supporting the passport + minimum rules
  - ***Addressing market failures*** arising from information asymmetries (which are intensified by the agency relationship which characterizes retail investor market engagement (intermediation) + behavioural risks)
- Response
  - Disclosure: efficient bargaining (caveat emptor colour)
  - + Product Design (portfolio allocation rules: UCITS) + Distribution (Investment Services Directive)
  - → Degree of Regulatory Paternalism + Market Shaping

Threshold Question (1)

- EU evolution stage 2 (→ 2008)
  - ***Empowering households/individuals***
  - Financialization; financial citizens
  - ***Long term saving*** through markets – 'mass market'/'mass affluent' (Commission policy) activity
  - ***Capital supplier*** notion
- Response
  - Disclosure + also financial literacy
  - Product range and accessibility (UCITS reforms; MiFID I and its support of access to execution-only distribution)
  - + Traditional malfeasance-directed intervention (MiFID I and distribution regulation)

Threshold Question (1)

- EU evolution stage 3 (reshaping by the Crisis and since)
  - ***Precautionary approach*** (down-cycle from the G20 agenda; 2012 OECD Principles)
    - Chimes with product intervention/governance
  - But ***importance of markets*** for consumer accumulation/decumulation
    - Ex: Robert Shiller and futures contracts on property prices
  - Deleveraging and Capital Markets Union and capital supply
- Response
  - MiFID II/MiFIR
    - Tougher distribution regulation; product intervention;/governance
  - Versus, eg, Capital Markets Union/2014 Long Term Investment Fund vehicle:
    - Raise and channel capital towards long-term investments

Threshold Question (1)

- → Recurring regulation v deregulation tension
  - Capital Markets Union agenda
    - Deregulation under 2015 Proposal for a Prospectus Regulation
    - Encouragement of crowdfunding
    - Retail Financial Services Green Paper (2015)
  - Product governance/intervention….

Threshold Question (2)

- **(2) Who is the beneficiary of product regulation?**
- Who is the targeted retail investor/consumer? How to design and supervise regulation?
- An elusive character
  - Household investment as discretionary speculation/asset accumulation and capital supply: caveat emptor
  - Household investment as necessary consumption of market-based products essential to managing the transfer of welfare provision from state to the citizen: (some) protection from market risk
  - → Financial consumers or retail investors? Or does it matter?
  - Implications for designing the new product system
    - Risk levels; understanding levels; thinking about outcomes/needs
- Empirical base strengthening
  - Evolution of the ESMA *Trends, Risks and Vulnerabilities Report* since 2011

Threshold Question (3)

- **(3) How to manage the challenges to the retail regulator/supervisor ?**
- Expectation risks
- Speed of retail market change
- Groupthink
- Arbitrage risk
- Reputational risk to regulator
- EU harmonization risks or opportunities?
  - Local experimentation pre MiFID II
  - The predominance of EU rules
  - ESA incentives for soft law and the Banking Union effect
    - ESMA/EBA….?

Risks of EU Product Regulation

- The most interventionist/newest form of retail market tool
  - Largely upstream tool
- Spectrum: ex-ante product authorization → **oversight/governance** → demarcation of public distribution/nature of distribution → prohibition/intervention (ex-ante or ex-post)
- Risks (relative to nature of intervention)
  - Arbitrage
  - Damage to innovation
  - Investor autonomy
  - Moral hazard and risk to regulator

Risks of EU Product Regulation

- Governing concepts can be slippery
  - "Fairness"; "Value" (UK approach)
    - "Outcome" against which UK FCA performance against statutory objective to "ensure that financial markets function well" is tested
      - "Consumers have access to fair products"
    - FCA Regulatory Guide on Responsibility of Providers and Distributors for Fair Treatment of Customers (2011) (over product life cycle); Structured Product Guidelines (2012)
      - 'Reasonable prospect of delivering economic value to end customers' (March 2015)
  - "Complexity"
    - UK and the simple products battle

Risks of EU Product Regulation

- New and relatively untested
- Excessive paternalism
  - Depending on execution of policy
  - Autonomy/innovation risks
  - Investor choice trumped by regulatory decision-making?

Risks of EU Product Regulation

- How to supervise?
  - Consumer perspective?
  - Segmenting consumers and their behaviours and investment drivers?
    - The regulator or the firm?
  - Understanding the process and the product
  - Difficult: the UK FCA example and structured products (March 2015)
    - Persistent weaknesses (Guidelines in 2012)

Risks of EU Product Regulation

- How to ensure firms establish appropriate outcomes for consumers/retail investors/meet needs?
  - Commercial incentives + matching product design to consumer/investor needs?
  - How to evidence that consumers/retail investors at heart of the design process? That products are meeting needs?
  - Embedding cultural change; business model challenge
- The balance between process + outcomes

Risks of EU Product Regulation

- + it is difficult to achieve outcomes
- Recent FCA experience with Structured Products (2015 Thematic Review)
  - 'Retail consumers' struggle to understand relative merits and factors driving returns – firms must bridge this gap
  - Senior management required to do more to put customers at forefront of product governance approach
  - Structured product should have reasonable prospect of delivering economic value to customers in target market; firms must be able to determine and evidence this
  - Clear and balanced information provision
  - Strengthening of monitoring of products
  - Firms need to do more across the product lifecycle to ensure customers treated fairly

But: EU Product Regulation is worth trying

- → A delicate supervisory challenge for 'law in action'
- But overall…a welcome innovation
- Has the current tool box worked?
  - No. Repeated cycles of recurring problems
  - Ex: the self placement problem
- Upstream/precautionary approach useful
- Strongly associated with internal firm processes, systems, and culture
- + Ancillary support to quality of advice regulation + support of better outcomes for non-advised consumers/investors
  - In light of potential MiFID II industry changes to investment advice

The Developing Regime: the Governance Example

- The development of ESMA's MIFID II technical advice (December 2014)
  - MiFID II Article 16 + 24 on product design processes/governance
- Extensive ESMA development process
- Technical Advice to Commission, December 2014

The Developing Regime: the Governance Example

- Commission response: Draft Delegated Act, Wednesday April 7 2016 (notes broad consensus with Parliament ECON Committee): Article 9 (manufacture) and 10 (distribution)
- Article 9: applies to manufacturing financial instruments, which encompasses the creation, development, issuance and/or design of financial instruments
- Firms to comply in a manner which is **appropriate and proportionate**, taking into account nature of the financial instrument, service, and product target market
- Procedures required so that manufacturing process complies with conflict of interest requirements, including on remuneration, and design does not adversely affect end clients, or lead to problems with market integrity, by enabling firm to mitigate/dispose of its own risks

The Developing Regime: the Governance Example

- Potential for conflict of interest risk must be examined each time a financial instrument manufactured
- Threats to financial stability assessed before product launch
- Staff engaged in manufacturing must have necessary expertise to understand character and risks of the financial instrument
- Effective control by management body
- Compliance function must monitor product governance
- Collaboration with third country firms must be documented by written agreement which sets out respective responsibilities

The Developing Regime: the Governance Example

- Target market must identify 'at a sufficiently granular level' potential target market and specify relevant type of client for whose needs, characteristics, and objectives the financial instrument is compatible
  - TM analysis include assessment that product not driven by business model that relies on poor client outcomes to be profitable
- Scenario analysis which assesses risks of poor outcomes (including if not commercially viable - but also if demand higher)
- Charges
  - Must not undermine return expectations
  - Appropriately transparent
- Review requirements
- Broadly similar to ESMA Technical Advice, less detailed in places (ie with respect to criteria which trigger a review of a financial instrument)

The Developing Regime: the Governance Example

- Recent UK FCA experience
  - Product regulation generally strongly associated with FCA's start up in 2013
  - Product intervention v. governance
  - Beyond regulation: soft Guidelines + supervisory thematic review
  - Structured products focus (2015 review)
  - The 'Innovation Hub' (2014)
    - Support of introduction of innovative financial products/services to the market
    - Encourage innovation in financial services; innovation as a driver of competition
    - Add more flexibility and remove barriers to entry
    - Does innovation offer 'identifiable benefits'?
    - Waiver/modification of rules
    - 'Informal steers'; individual guidance