

Franke, Günter; Mosk, Thomas; Schnebel, Eberhard

Working Paper

Fair retail banking: How to prevent mis-selling by banks

SAFE White Paper, No. 39

Provided in Cooperation with:

Leibniz Institute for Financial Research SAFE

Suggested Citation: Franke, Günter; Mosk, Thomas; Schnebel, Eberhard (2016) : Fair retail banking: How to prevent mis-selling by banks, SAFE White Paper, No. 39, Goethe University Frankfurt, SAFE - Sustainable Architecture for Finance in Europe, Frankfurt a. M., <https://nbn-resolving.de/urn:nbn:de:hebis:30:3-412367>

This Version is available at:

<https://hdl.handle.net/10419/144161>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.



Günter Franke, Thomas Mosk and Eberhard Schnebel

Fair Retail Banking: How to Prevent Mis-selling by Banks

White Paper No. 39

SAFE | Sustainable Architecture for Finance in Europe

A cooperation of the Center for Financial Studies and Goethe University Frankfurt

House of Finance | Goethe University
Theodor-W.-Adorno-Platz 3 | 60323 Frankfurt

Tel. +49 69 798 33684 | Fax +49 69 798 33910
policy_center@safe.uni-frankfurt.de | www.safe-frankfurt.de

SAFE Policy papers represent the authors' personal opinions and do not necessarily reflect the views of the Research Center SAFE or its staff.

Fair Retail Banking:

How to Prevent Mis-selling by Banks

Günter Franke*, Thomas Mosk** and Eberhard Schnebel***¹

July 6, 2016

Executive summary

Mis-selling by banks has occurred repeatedly in many nations over the last decade. While clients may benefit from competition – enabling them to choose financial services at lowest costs – economic frictions between banks and clients may give rise to mis-selling. Examples of mis-selling are mis-representation of information, overly complex product design and non-customized advice. European regulators address the problem of mis-selling in the “Markets in Financial Instruments Directive” (MiFID) I and II and the “Markets in Financial Instruments Regulation” (MiFIR), by setting behavioral requirements for banks, regulating the compensation of employees, and imposing requirements on offered financial products and disclosure rules.

We argue that MiFID II protects clients but is not as effective as it could be. (1) It does not differentiate between client groups with different levels of financial literacy. Effective advice requires different advice for different client groups. (2) MiFID II uses too many rules and too many instruments to achieve identical goals and thereby generates excessive compliance costs. High compliance costs and low revenues would drive banks out of some segments of retail business.

In analogy to the Basel framework, we rely on a three pillar approach to protect clients on the one hand and to enable banks to earn the cost of capital in retail banking on the other hand. In order to improve customized advice, we argue that client protection should be based on fewer regulation worded as rules and more regulation phrased as principles. Tight rules are appropriate when details of effective interaction between banks and clients are well-known. Principles, by contrast, provide behavioral guidelines and grant more discretion so that interaction can be adapted to a broad range of situations, including heterogeneity of clients and of employees.

In the proposed three pillar approach, rules for banks’ interactions with retail clients are encoded in Pillar 1, principles for fair treatment of clients in Pillar 2. A supervisory review process to check the bank’s interaction with retail clients is the core of Pillar 2. Market discipline, finally, forms Pillar 3 and may be promoted through feedbacks of clients on their interaction with banks and standardized product disclosures. This approach should ensure high levels of client protection and promote the quality of advice, while limiting the compliance costs of banks so that they are able to earn the cost of capital retail banking entails through retail banking activities. Thus, the approach aims at a fair and viable compromise between the interests of clients and those of banks.

* Günter Franke, Research Professor at the Research Center SAFE and the University of Konstanz (guenter.franke@uni-konstanz.de). Corresponding author.

** Thomas Mosk, Goethe University Frankfurt, Research Center SAFE.

*** Eberhard Schnebel, Commerzbank AG and Lecturer at the Center for Business Ethics, Goethe University Frankfurt.

¹ The Task Force gratefully acknowledges the cooperation with Miriam Shabafrouz, Alexandra Engel and Hans-Helmut Kotz, all at the Research Center SAFE. Moreover, Andreas Hackethal and Jan Krahnert, also at SAFE, provided valuable comments for improving the paper.

Introduction

Mis-selling by banks in retail business can be explained by economic frictions between banks and their clients, driven by different levels of expertise, different levels of transaction costs and different access to financial markets. Without such frictions, there would be no reason to protect clients through special regulation. An important source of these frictions is the financial (il)literacy of clients.² Financial (il)literacy is a multi-dimensional construct covering the understanding of financial concepts such as return, risk and reward, money and transactions, planning and managing personal finance, identifying and analyzing financial information, and relating it to individual and family contexts. Von Gaudecker (2015) finds that people with low financial literacy typically under-diversify their portfolios and that people who score high on financial literacy or rely on professional advice, achieve reasonable investment outcomes.³ Lusardi and Tufano (2009) assess that financial literacy is low to an extent that, for example, only about one third of the population understands how interest compounding is functioning.⁴ Bucks and Pence (2008) as well as Bergstresser and Beshears (2010) observe that many borrowers do not understand the mechanics and risks of adjustable-rate mortgages.⁵

Although measurement of financial literacy is not a trivial task, it is obvious that financial literacy of many retail clients is far below that of banks and their employees. This gap creates an information asymmetry⁶ which provides room for mis-selling, exemplified by mis-representation of information, complex product design and non-customized advice.

The Markets in Financial Instruments Directives (MiFID) I and II bring up many new rules that banks have to follow in retail banking.⁷ Their objective is to reduce the effects of the gap between banks and their clients in terms of financial literacy, market expertise and bargaining power. MiFID assigns to almost every recognized problem a special rule, designed to improve the servicing of clients. However, these rules may also weaken bank competition. This creates a regulatory dilemma: Strict regulation

² See OECD (2013): Financial Literacy Framework, in PISA 2012 Assessment and Analytical Framework: Mathematics, Reading, Science, Problem Solving and Financial Literacy. OECD Publishing.

³ von Gaudecker, H. (2015): How Does Household Portfolio Diversification Vary with Financial Literacy and Financial Advice?, *Journal of Finance* 70, 489-507.

⁴ Lusardi, A., P. Tufano (2009): Debt Literacy, Financial Experiences, and Overindebtedness. NBER Working Paper No. 14808.

⁵ Bucks, P., K. Pence (2008): Do borrowers know their mortgage terms? *Journal of Urban Economics* 64, 218-233. Bergstresser, D., J. Beshears (2010): Who Selected Adjustable-Rate Mortgages? Evidence from the 1989-2007 Surveys of Consumer Finances. Harvard Business School, Working paper 10-083.

⁶ Whenever we talk about the degree of information asymmetry, we refer to the size of the gap in financial literacy between the bank and the client. To simplify matters, we use size as a one-dimensional concept, keeping in mind that the gap is multi-dimensional, including behavioural biases of clients.

⁷ We focus on MiFID which is a directive: it needs an appropriate adoption and implementation into national law and leaves Member States the choice of form and methods thereof. MiFIR is the corresponding regulation to MiFID: it is self-executing and directly applicable in the Member States. As such it is presumably the more concrete legal text.

could benefit the retail clients who are serviced by a bank, but endanger the provision of competitive financial services to other client groups.⁸

This paper provides an analysis of the MiFID II rules in order to understand their likely, unintended consequences for the quality of financial services in retail banking. It also proposes rules and principles in a three pillar framework to improve retail banking. As MiFID II has not been implemented yet, empirical data on its effectiveness to substantiate our arguments are currently not available. Instead, we first analyze the three observed types of mis-selling, i.e. mis-representation of information, complex product design and non-customized advice. Then we check to what extent the MiFID II rules effectively reduce the economic frictions between the client and the bank, particularly in a world of heterogeneous clients. Lastly, we analyze whether the rules entail unintended consequences, such as excessive compliance costs and potential exclusion of client groups from bank services. Based on that, we propose substantial changes to the MiFID II approach, using robust economic arguments.

We interviewed banking professionals to capture expected effects and interactions of the different rules and assess the appropriateness of efforts financial institutions have to take in order to meet the claims and specifications of MiFID II. Even though some answers of banking professionals may be biased, they are useful guidelines to understand the effects of MiFID II.

Our conclusion is that MiFID II strengthens client protection. However, it largely ignores heterogeneity of retail clients, imposes unnecessarily high transaction costs on banks, lowers their revenues and, thus, endangers profitability of retail banking and, as a consequence, socially desirable bank services to clients.

The three pillar framework that we offer in this paper may be a solution to this regulatory dilemma. It combines rules and principles for fair retail banking taking into account the importance of an optimal combination of these two instruments. Rules are appropriate when details of effective, socially desirable interaction between banks and clients have been clearly identified. Principles, by contrast, derive from general values and only provide behavioral guidelines instead of rigid instructions. They can be adjusted to the specific needs of a certain client relationship, in particular to the client's observed financial literacy.

⁸ Such a detailed regulation governing the interaction of a firm and its clients is only observed in a few industries including medical and financial advice. The justification for this are the potentially disastrous consequences for the client if he is given wrong advice. For illustration, recently some retail clients of Italian banks lost all their money because the banks advised them to buy bank bonds which then were bailed-in when the banks went bankrupt. The regulator should prevent such disasters in spite of the regulatory dilemma.

Pillar 1 of our framework specifies rules for a bank's interaction with retail clients. In Pillar 2, similarly to the Basel framework⁹, a supervisory review process backs up the implementation of such rules as well as the implementation of principles. Pillar 3 aims at ensuring market discipline and is endorsed by more transparency about the quality of retail services. This should help to cut back mis-selling and to motivate banks to build a strong reputation in retail banking. The three pillar framework is based on fewer detailed rules than MiFID II and leaves room for optimizing the portfolio of different instruments to ensure client protection. It should reduce compliance costs, while providing higher levels of protection for clients and better advice.

This paper does not address the regulation of bank behavior in financial markets as done in the Market Abuse Directive, in MiFID II and other European directives and regulations. Further, it does not address litigation issues.

The paper is structured as follows: Section 1 describes three types of mis-selling which may occur between the bank and the client. In section 2, the paper explains which instruments MiFID II uses to protect clients. While MiFID II offers client protection, it is likely to produce unintended consequences, in particular high compliance costs, which could drive banks out of some client segments (section 3), also illustrated in the box on p. 11-12 which summarizes interviews with bank representatives. Section 4 proposes a three pillar framework based on rules and principles to improve regulation. Section 5 shows how this framework could be applied to the MiFID instruments for client protection. In addition, this last section discusses two important caveats of the paper which are (i) difficulties in identifying mis-selling and (ii) the material content of the client's interests.

1. Mis-selling

In this chapter, we exemplify mis-selling through (1) mis-representation of information, (2) complex product design, and (3) non-customized advice. For each type we discuss economic mechanisms which give rise to the problem and some remedies proposed in the literature.

⁹ European countries adopted different national approaches to supervise financial institutions. In some countries one institution supervises banks' risks and risk management and their financial conduct towards customers (for example, France and Germany) while other countries established separate institutions (for example, the UK). For details see the EBA website, <http://www.eba.europa.eu/consumer-corner/national-competent-authorities-for-consumer-protection>. The EBA is also responsible for consumer protection. In addition, other European organizations may take an active role.

1.1. Mis-representation of information

Material mis-representation of information is the deliberate hiding or falsification of a material fact which, if known to the other party, could have aborted or significantly altered the basis of a contract, deal, or transaction.¹⁰ Mis-representation of information implies biased or even fraudulent advice.

In the British retail market, for example, the former bank Alliance & Leicester (A&L) failed to inform their clients about the significant features, limitations and exclusions of the widely sold Payment Protection Insurance (PPI). In their sales activities on the phone, they did not make it sufficiently clear to clients that PPI was optional. When clients objected to or questioned the purchase of PPI, A&L's advisers were trained to use inappropriate sales techniques that put pressure on the client to buy PPI (FSA 2008).¹¹ This is a typical example of an adverse selection problem between the seller (the bank) and the buyer (the client) of a security, in which the seller has more information about the characteristics of the product than the buyer.

This type of mis-representation is not only occurring between banks and retail clients, but also between banks and other banks as documented by penalties which banks had to pay for mis-representing the risks embedded in securitization tranches. Similarly, banks have not always drawn their clients' attention to the counterparty risks involved in the purchase of financial certificates. It has also been common to charge fees which are not easy to detect by clients, for example, high margins in foreign exchange transactions. Anagol, Cole and Sarkar (2013)¹² observe that banks use to sell financial products with high commissions if they do not need to disclose commissions of these products. A particular example of mis-representation of information has been analyzed by Fecht, Hackethal and Karabulut (2013).¹³ They find that banks tend to abuse their advisory role to dump low performing stocks from their proprietary portfolio into clients' portfolios. In all these cases, the banks have benefitted from some financial illiteracy of their clients. Regulation should penalize this type of material mis-representation of information.

Of course, to be fair, there is no conclusive empirical evidence whether or not advice is mostly beneficial to clients. Some papers find a positive effect of advice on a client's portfolio performance (Shapira

¹⁰ A related problem is fraud. Fraud is a deception deliberately practiced in order to secure an unfair or unlawful gain. An example of a fraud is incorrect reporting of a credit applicant by vastly overstating his income.

¹¹ Financial Service Authority (2008): Final Notice: http://www.fsa.gov.uk/pubs/final/alliance_leicester.pdf.

¹² Anagol, S., Cole, S., S. Sarkar (2013): Understanding the Advice of Commissions-Motivated Agents: Evidence from the Indian Life Insurance Market, Harvard Business School, Working Paper 12-055.

¹³ Fecht, F., A. Hackethal, Y. Karabulut (2013): Is proprietary trading detrimental to retail investors? Discussion paper, Deutsche Bundesbank No 42/2013.

and Venezia 2001, von Gaudecker 2015, (see footnote 3) while others do not identify any impact (Kramer and Lensink 2012).¹⁴ Well-known are the many empirical papers which show that mutual funds mostly perform worse than passive exchange traded funds.

1.2. Complex product design

Another form of mis-selling can be caused by a complex product design. Financial intermediaries may design products which are too complex for clients to understand or which include risk factors that provide no benefit to the client.¹⁵ The problem of mis-selling arises if clients are not in a position to uncover all features of a product which are relevant for its payoff, unless they incur high cognitive costs before the purchase (Zhao 2014).¹⁶ For example, some recent structured retail products combine more than 5 non-linear payoff characteristics which are usually unrelated to the client's financial needs. Why would financial intermediaries design products which are too difficult to understand for their clients? Carlin and Manso (2011) argue that financial intermediaries realize that clients need to incur learning costs to understand the product, and choose product complexity strategically to extract rents from unsophisticated clients.¹⁷ Regulation should prevent such obfuscation driven by product complexity.

1.3. Non-customized advice

Customized advice is expensive for banks. It may not pay off in the case of clients with modest wealth. If the bank invests very little time to find out about a client's financial and private situation and risk preferences, product advice cannot be tailored to his needs.¹⁸ Inderst and Ottaviani (2009) highlight an inherent conflict between the two tasks performed by sales agents to explain mis-selling: prospecting for clients on the one hand and advising on the product suitability for the specific needs of the clients on the other hand.¹⁹ When banks provide strong incentives to prospect clients (e.g. via sales

¹⁴ Shapira, Z., I. Venezia (2001): Patterns of behavior of professionally managed and independent investors, *Journal of Banking & Finance* 25, 1573-1587; Kramer, M., R. Lensink (2012): The Impact of Financial Advisors on the Stock Portfolios of Retail Investors, Working Paper, Groningen University.

¹⁵ Célérier and Vallée (2015) measure product complexity by the number of product payoff features. They analyze 55,000 European structured retail products and show that financial complexity has increased even after the financial crisis and that the bank's mark-up on these products is an increasing function of its complexity. This study provides empirical evidence that banks benefit from designing complex products. Celerier, C., B. Vallee (2015): Catering to Investors through Product Complexity, HEC Paris Research Paper No. FIN-2013-1013.

¹⁶ Zhao, X. (2014): Strategic Mis-selling and Pre-Contractual Cognition. Working Paper. Hong Kong University of Science and Technology.

¹⁷ Carlin, B., G. Manso (2011): Obfuscation, Learning, and the Evolution of Investor Sophistication, *Review of Financial Studies* 24, 754-785.

¹⁸ Foerster, Linnainmaa, Melzer and Previtro (2014) study the impact of financial advisers on the portfolio of Canadian households. They find that advisers induce their clients to take more risk, thereby raising expected returns. On the other hand, they find limited evidence of customization: advisers direct clients into similar portfolios independent of their clients' risk preferences and stage in the life cycle. This implies that advisers give a one-size-fits-all advice instead of adjusting their advice to the needs of the customer. Overall they find that the benefits of financial advice do not outweigh the costs. Foerster, S., J. T. Linnainmaa, B. T. Melzer, and A. Previtro (2015): Retail financial advice: Does one size fit all?, *Journal of Finance*, forthcoming.

¹⁹ Inderst, R. and M. Ottaviani, 2009: (Mis)selling through Agents, *American Economic Review* 99(3), 883-908.

bonuses), the sales agent will be tempted to inflate the perceived value of the product or recommend the product even if it is not suitable for the client. Bolton, Freixas and Shapiro (2007)²⁰ developed a model in which some clients are partially uninformed in the sense that they do not know which financial product best suits their needs. This assumption allowed them to model a standard conflict of interest in the financial industry that may give rise to mis-selling of financial products: should a financial intermediary tell a client that another firm offers a product that suits the client's needs better, or should he try to steer the client to one of its own products? The authors show that banks usually withhold information on more suitable products of competitors and rather sell their own products. Both papers exemplify situations in which non-customized advice benefits the bank. Regulation should take care of this problem and urge banks to provide customized advice.

2. Consumer protection in MiFID II

Mis-selling of financial products is socially undesirable and creates a need for regulation to protect clients. This section discusses key instruments which the Markets in Financial Instruments Directive (MiFID) uses to provide this protection.

MiFID is an EU directive that provides harmonized regulation for investment services across the 28 Member States and has also been adopted by the three additional members to the European Economic Area Iceland, Norway and Liechtenstein. The first version of MiFID, now called MiFID I, was implemented in 2004. The directive's main objective was to improve client protection in investment services and to enhance the stability and efficiency of the financial system. In 2011, the European Commission adopted a new set of rules to further strengthen client protection, the so-called MiFID II. It will replace MiFID I by 2018. MiFID II aims at addressing the shortcomings of MiFID I and takes into account the lessons learnt during the financial crisis. Chapter 2 of MiFID II focuses on the operating conditions for investment firms and includes 13 articles on the governance of the relation between investment firms and their clients. The main goal of these articles is to ensure the provision of suitable advice to clients. The articles address various instruments of bank policy to protect clients: (1) They impose behavioral requirements on investment firms and their employees, (2) they regulate the compensation of the employees, (3) they impose requirements on product development and usage, and (4) they impose disclosure rules on banks. Below we briefly discuss these four instruments of protection.

2.1. Setting behavioral requirements

Sales agents might not spend enough effort to service clients. Therefore, MiFID II sets rules how advisers should behave in their relationship with their clients. For example, advisers should dispose of the

²⁰ Bolton, P., X. Freixas, J. Shapiro (2007): Conflicts of interest, information provision and competition in the financial services industry, *Journal of Financial Economics* 85, 297-331.

necessary knowledge and competence to fulfill their obligations (art. 25.1), they should obtain information about the client's knowledge, experience and investment objectives (art. 25.2), warn clients about potential risks (art. 24.4, art. 25.5) and report to clients about the suitability and appropriateness of products (art. 25.6). These rules emanate from a strong intention to enforce social preferences on the client-bank relationship.

2.2. Regulating the compensation of employees

Advisers also might try to sell products to maximize their compensation (bonus). Therefore MiFID II (art. 24.10) imposes strict limits on the compensation of financial advisers:

“An investment firm ... shall ensure that it does not remunerate or assess the performance of its staff in a way that conflicts with its duty to act in the best interests of its clients. In particular, it shall not make any arrangement by way of remuneration, sales targets or otherwise that could provide an incentive to its staff to recommend a particular financial instrument to a retail client when the investment firm could offer a different financial instrument which would better meet that client's needs.”

To preclude conflicts of interest regarding the recommendation of financial instruments, independent advisers and portfolio managers are not allowed to accept fees, commissions or any benefit from a third party in relation to the service for the client (art. 24.7, 24.8).

2.3. Imposing product requirements

Several MiFID II articles address the problem of product complexity. Under the new directive, investment firms are required to maintain, operate and review the process for the approval of each financial product. The product approval process should specify a target market of end clients and ensure that all relevant risks to the identified target market are assessed. In addition, an investment firm should regularly review financial instruments it offers (art. 16.3). Investment firms should ensure that financial products are designed to meet the needs of an identified target market of end clients (art. 24.2) and provide information in a comprehensible and standardized form (art. 24.5). MiFID II also requires that investment firms periodically report to the clients how their advice meets the preferences, objectives and other characteristics of the client (art. 25.6). The requirements for the approval of new products and the reporting rules on the appropriateness of the products set limits on investment firms to develop overly complex products. While existing client protection regulation primarily focuses on disclosure, this set of new rules gives the regulator more power to intervene at the stage of product design.

2.4. Imposing disclosure rules

MiFID II aims at reducing the mis-representation of information by forcing investment firms to disclose to the client the nature and sources of conflicts of interest (art. 23.2, 23.3), to satisfy disclosure re-

quirements on products and costs (24.4 and 24.5), to disclose all fees and commissions (24.9), to disclose costs and risks in selling bundles of financial products (24.11) and disclose the execution policy (27.5). These extensive disclosure rules should increase the transparency of financial products and transparency about potential conflicts of interest.

These rules are in line with the objective of the European Commission (2015) to create a true European market for retail financial services.²¹ To achieve this objective, all Member States are supposed to implement the same product requirements and disclosure rules. That should facilitate product comparisons across countries by retail clients. It would also reinforce competition among advisers which, in turn, probably motivates advisers to provide better advice (Anagol, Cole and Sarkar (2013), see footnote 12).

3. Unintended consequences of MiFID II

MiFID II is an important directive to protect bank clients *against* mis-selling. We argue in this section that MiFID II protects clients, but is quite costly and could drive banks out of servicing a client segment. We interviewed representatives of three large banks based in Frankfurt to investigate the impact of MiFID II on their business. The results of these interviews are reported in the box at the end of this section.

An important unintended consequence of MiFID II will likely be that low revenues and high compliance costs may exclude some client groups from financial advice. Banks may consider giving up a segment of retail business if they cannot earn their cost of capital in this particular segment. Low revenues are implied by the requirement that the bank has to act in the best interest of the client and by the prohibition of charging a transaction commission. Hence, a bank would have to charge a separate fee for advice. In the UK the Retail Distribution Review is in effect since 2013. It prohibits commission-based advice. The experience in the UK indicates that banks provide little or no personal advice to retail clients with moderate wealth.²² Instead they try to sell them mainly standardized products and refer them to websites for additional and concrete advice. Thus, this regulation potentially excludes a significant group of clients from personalized advice and thereby fosters mis-selling.

MiFID II is costly because it imposes many strict rules which lead to high transaction costs. In particular, the newly imposed requirements for documentation and disclosure in art. 23 and 24 increase the costs of banks. MiFID II also requires banks to inform the client about all relevant properties of a financial

²¹ European Commission (2015): Green paper on retail financial services: better products, more choice and greater opportunities for consumers and businesses.

²² Cass consulting (2013): The impact of the RDR on the U.K.'s market for financial advice, Electronic publication (June) at www.cassknowledge/cass-consulting.

product, including all costs charged by the bank and all risks of a financial product or investment strategy. Given the time limits for personal advice, it will be impossible to inform the client about all relevant properties of a financial product. This is particularly true if the client has little knowledge about financial products and risks. Therefore the adviser has to carefully select the most important pieces of information for his conversation with the client. But this, in turn, exposes him to a compliance risk.

Moreover, MiFID II does not differentiate between client segments with different levels of financial literacy. Differences in financial literacy generate different client needs for advice and for protection. Enforcing the same rules for all clients regardless of the heterogeneity of their financial literacy ignores client-dependence of good advice and, therefore, promotes mis-selling. It also raises the cost of retail banking unnecessarily so that money is wasted. In addition, client preferences change over time. If the bank employee has to newly assess them whenever the client asks for advice, he will have to spend a substantial part of his time on this. Hence, ex post it might be quite difficult to find out whether the bank acted in the best interest of the client at the time of the sale. This creates a legal risk for the bank.

Finally, MiFID II requires investment firms to use different instruments (bank organization and employee behavior, compensation, product requirements, disclosure rules) to protect clients. These instruments are potentially substitutes for each other. Using many instruments simultaneously to achieve the same goal could result in over-regulation. Therefore setting high standards for each instrument may lead to excessive compliance costs and to a waste of money.

Box: Bank employees' assessment on MiFID II

For investigating the implementation of MiFID II, we conducted in-depth interviews with representatives of three large banks, headquartered in Frankfurt during winter 2014/15. The main findings are summarized in the following along the lines of what MiFID II is aiming at – and what might be its unintended consequences.

Context

The bank representatives were experts working in the departments of legal affairs or strategy, all being involved in the consultation phase of ESMA on MiFID II. They waited for its final version to translate the provisions into conduct rules and legal trainings within their banks. The bank representatives expected the consultation process to lead to further changes of specific provisions of the regulation, making it difficult for them to prepare early for these changes. In March 2015, it was still difficult to predict the final form of MiFID II scheduled to be implemented by 2017. The short time span left to banks to adapt to the new regulation was identified as one core problem that might engender difficulties of implementation and bears the risk of costly mistakes. The delay of the start of MiFID II to 2018, as decided in November 2015 by the European Parliament and Commission, might play in the banks' favor.

Effectiveness

MiFID II requires the disclosure of information whether the investment advice is provided on an independent basis or not. If so, it bans commissions or fees between the investment firm and third parties (art. 24.4, 24.5., 24.7.b, 24.8.). This, however, does not imply a strict ban on commissions as there are already many mixed methods of remunerating advice to obviate this rule as well as to invalidate its aim.

Conflicts of interest cannot be solved. The issue of conflicts of interest between an investment firm and a more or less unskilled client, which is a main focus in MiFID II, is dealt with through more disclosure. Still, conflicts continue to exist and could at most be balanced – and never solved – by regulation.

No distinction between customer segments means more equality – but not necessarily more efficiency. MiFID does *not* distinguish between professional, private or institutional clients – all have to be treated equally in terms of documentation and information. The more sophisticated the customers of a segment, the more products are offered by banks so that more documentation has to be processed and understood. In Germany, the requirement of reporting has already existed since 2010, but MiFID II will change some of the requirements. One big ambivalent issue linked to the consulting protocol is the question whether or not the client should sign it – because this would fundamentally change its legal reliability and, hence, have an impact on a banker's motivation to write the report accurately and in detail, but also on his caution in the advisory process.

The service in regional and remote areas poses increasingly a challenge. Special challenges occur when providing good advice countrywide: in cities with many clients, competition is strong so that specialized advisers are in place. But in areas with low population density, advisers need to be all-rounders who sometimes have difficulties to fulfill every new regulatory requirement. The banks make a difference between different types of clients (for instance private clients; a middle segment of wealthy clients and a small segment of private banking).

Complexity

Complexity is not really resolvable by simply providing more information. The amount of information meets its limits in the time constraints of both the banker and his client, and also in what the client can (and wants to) digest.

A bank could never completely resolve the complexity problem by educating the customer. The duration of a talk often takes only half an hour which may be too short for explaining every eventuality and every detail of a complex product. The retail advisers have to fulfill more and more requirements within this time slot. It would be helpful, as one said, to have a standardized set of terms and details that can be handled in appropriate time by the adviser as well as by the client.

The complexity of products is multi-dimensional – and the advisers sometimes don't know every aspect of products themselves. Many products like exchange traded funds (ETFs), but also stocks or options are complex products when considering the different possibilities of their construction. In a short time, the adviser needs to test the client for his risk appetite, his knowledge of financial instruments, his awareness of key risks, his time horizon and his financial wealth. Different categories of products (A: easy to F: difficult) (bonds, derivatives, stocks...) designed for different categories of clients are not enough for handling critical risks.

Unintended Consequences

Not every client can afford to pay a consulting fee; therefore other kinds of fees are likely to remain in place. As a matter of fact, the banks live from their turnover and the operating profit of this turnover, which mainly depends on the satisfaction of their customer base.

Remuneration of advisers is handled differently by the banks. Often commissions are rather pooled than allocated to single advisers, but the pooled commission or part of it may be distributed among advisers. If no commissions were allowed, the adviser would more likely focus on a low number of products which would probably impact on the quality of advice.

4. Three pillars for fair retail banking

In this section, we propose a system of rules and principles to improve the desired level of client protection and quality of advice, while reducing the costs for banks of MiFID II due to high transaction costs and low revenues implied by overly strict rules.

A stronger emphasis on principles combined with fewer rules should better protect clients and lower costs. A stronger emphasis on principles, however, requires more monitoring by some supervisor. Firstly, this section briefly discusses the advantages and disadvantages of rules and principles in regulation and the optimisation problems involved. Secondly, it proposes how to translate MiFID II into rules (Pillar 1) and principles (Pillar 2) and how to improve market discipline in retail banking (Pillar 3). Thirdly, this section discusses how the three pillars should cut back mis-selling.

4.1. Advantages and disadvantages of rules and principles in regulation

There is a long standing debate about the relative merits of rule-based versus principle-based regulatory systems in accounting (Arjoon 2006) and law (e.g. Korobkin 2000).²³ Rule-based regulation prescribes in detail how to behave (e.g.: “On Dutch highways the speed limit is 120 km/hour”). In principle-based regulation, norms are formulated as guidelines or objectives (e.g.: “Drive responsibly when it is snowing”). The exact implementation of the norm is left to the subject.

The purpose of rules and principles is to define an institutional framework which induces socially desirable interaction between the involved parties. Whenever this interaction is well known for a particular situation, then a rule may prescribe this for that situation. If a socially desirable interaction depends on various factors, a rule would have to specify the behavior of the involved parties as a function of all these factors which is usually impossible. Therefore, principles which define objectives for the involved parties how to choose between different actions are preferable. If the parties adhere to these principles, socially desirable interaction is most likely. In a fast changing environment, which is typical for financial markets, principles are likely more effective than inflexible rules.

The advantages of rules in banking are that they provide clarity, certainty and transparency for bank managers. Rules are operational, principles are not. Disadvantages of rules are that, due to their inflexibility, they may enforce socially undesirable interaction in various situations and, thus, may create incentives for excessive litigation. Moreover, rules invite legal arbitrage and gaming. Very detailed rules may require detailed contracts and detailed behavioral procedures which cause high transaction costs. In contrast, principles provide flexibility and greater freedom for bank managers, but require deliberate decision-making and coordination with other parties. Thus, more human intelligence is necessary. As a disadvantage, the interpretation of principles may involve subjective perceptions. But these perceptions may be a necessary ingredient for a sensible application of principles. Therefore principles are more difficult to enforce.²⁴

Banks relying on a mixture of rules and principles might use their discretion to their own benefit – at the expense of their clients. In order to protect less sophisticated clients, more discretion of the bank

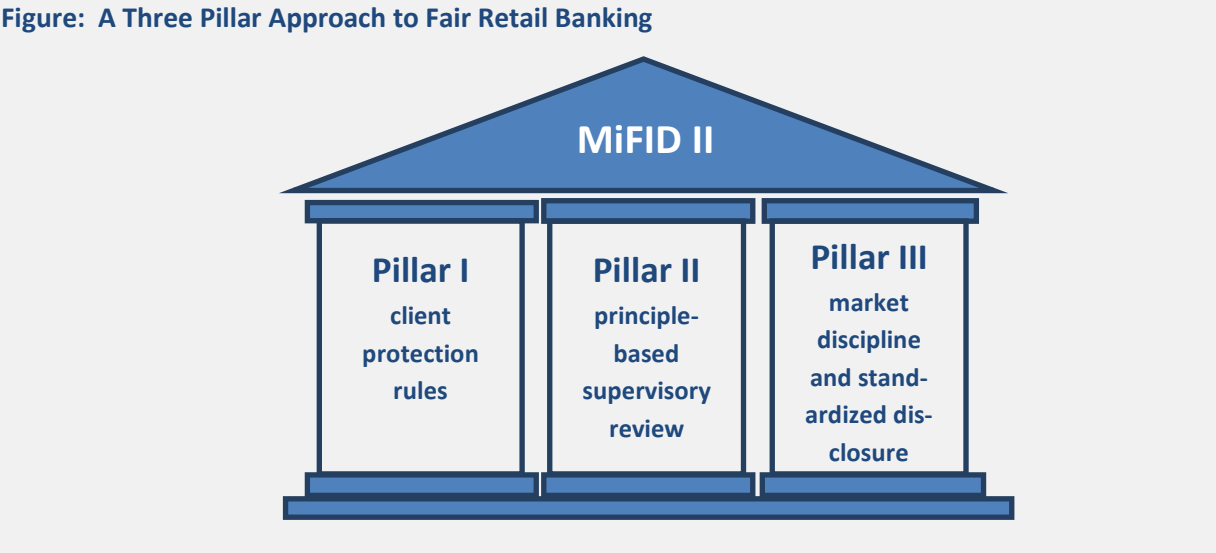
²³ Arjoon., S. (2006): Striking a balance between rules and principles-based approaches for effective governance: A risks-based approach, *Journal of Business Ethics* 68, 53-82; Korobkin, R. B. (2000): Behavioral analysis and legal form: Rules vs. principles revisited, *Oregon Law Review* 79(1), 23-60.

²⁴ This discussion is also related to different schools of law, as found in several Continental European (principles-based) vs. Anglo-Saxon (rules-based) legal traditions. These schools translate complexity into detailed contracts that are sometimes very comprehensive, as in the Anglo-Saxon tradition, while in the European tradition contracts often are confined to some fundamental principles, leaving room for interpretation and therefore requiring shared understanding and commitment. Currently we might witness a shift to more detailed and rules-based contracts in Continental Europe.

should be accompanied by more external monitoring by a bank supervisor who is an expert in retail banking. There are different ways to implement this concept. As the problems have some similarity to those in the regulation of adequacy of bank capital and risk management, we propose a three pillar approach similar to the regulatory framework laid down in Basel III. Our approach is based on rules imposed on banks (Pillar 1), on principles and a supervisory review process (Pillar 2) and on market discipline supported by disclosure of reports on the quality of the banks’ interaction with its retail clients (Pillar 3). This three pillar approach should empower responsibility of banks to signal fairness and diligence in dealing with their retail clients. It should serve to balance the conflicts of interest between banks and clients, i.e. it should promote effective advice and allow banks to earn the cost of capital inherent in this business.

The difference between the current regulatory approach and our approach is that the rules in Pillar 1 are deemphasized while principles and the supervisory role in Pillar 2 are strengthened. One might assume that the overall cost of regulation would be minimized through a large set of rules in Pillar 1 and a strict implementation of these rules. As a consequence, the bank and the supervisor would need to spend little time on Pillar 2. But as argued before, stricter rules are likely to ignore the heterogeneity of clients. Hence, there is a conflict between economies of scale achieved by strict rules which apply to every client and the quality of advice for heterogeneous clients. MiFID II includes many detailed strict rules which are likely to miss an optimal balance between rules and principles. Therefore we advocate for more discretion of banks, balanced by more monitoring. In the following paragraphs, we will present the different pillars in more detail and link them to several principles we consider essential for fair retail banking. The below Figure illustrates our three pillar approach.

Figure: A Three Pillar Approach to Fair Retail Banking



Clearly the regulator needs to prescribe un-controversial rules and un-controversial principles (external rules and principles). As the implementation of socially desirable retail banking is subject to many unknowns, the bank itself should state additional rules and principles (internal rules and principles) governing its behavior. It should observe and evaluate the strengths and weaknesses of the package

of internal and external principles and rules. In this process, the bank should adjust its internal principles and rules to improve the interaction with its clients. Also the supervisor may not be satisfied and therefore urge the bank to change its internal rules and principles. In the following sections, we suggest some external rules and principles.

4.2. Pillar 1: Consumer protection rules

Pillar 1 contains a set of detailed protection rules prescribed by the regulator that govern the bank-client relationship. The rules are prescriptive, enforceable and leave little room for misunderstanding. With regard to our previous argumentation, we suggest that Pillar 1 includes only rules that do not distinguish between client groups. For example, these rules should require banks to always obtain information about a client's knowledge, experience and investment objectives and his financial needs (MiFID II, art. 25.2). The rules should also oblige banks to report to clients about the suitability and appropriateness of products (art. 25.6) and their risks (art. 24.4, 25.5). Also rules should require banks to disclose potential conflicts of interests (art. 23.2, 23.3), in particular, profit margins of products and services offered.

4.3. Pillar 2: The supervisory review process

The experience with rules in Pillar 1 of the Basel framework clearly indicates the general deficiencies of rules in banking regulation. Due to many human and market factors and their sometimes complicated interactions, the rules of interaction with retail clients in Pillar 1 of our approach can similarly only achieve limited protection for clients. Therefore principles have to make up for shortcomings of rules. The regulator and the bank design these principles and the bank implements them. As principles allow for more discretion of the bank, client protection requires a stronger role of the supervisor. The purpose of Pillar 2 is twofold. First, the supervisor should check whether the banks observe the rules in Pillar 1. If not, the supervisor should enforce compliance with rules. Second, the supervisor should check whether the banks sensibly implement principles for their interaction with retail clients. If not, the supervisor and the bank should jointly develop better processes for interacting with clients. In order to limit the cost of this supervisory process, the supervisor should not be involved in every detail. He should not analyze interactions with single clients unless there is evidence of systematic misconduct of the bank. Thus, his role should be less prominent relative to that in the Basel III framework.

We propose a few principles. Since regulation should strive for a fair balancing of interests of clients and banks, we propose as a first principle:

Principle A: The bank has to act in the best interest of the client subject to the condition that it earns the competitive cost of capital inherent in this business segment.

This principle explicitly addresses the necessity of a compromise between the interests of the bank and the client. Such a compromise is a requirement for the viability of the bank's retail business. If this

principle is observed, clients benefit from the service of the bank and the bank earns the competitive cost of capital. This cost is defined as the cost incurred by a bank which operates competitively in this business segment. It is independent of the cost of capital of a given bank. Hence, a bank with a higher cost of capital may exit from this business segment or improve its competitiveness to lower its cost of capital. Under Principle A, a competitive bank and its retail clients have an ongoing interest in interacting with each other. Sensible regulation should try to anticipate the equilibrium in bank-client interactions which is likely to emerge under the regulation. This equilibrium determines whether the regulation achieves the desired objectives in the long run.

Principle A addresses the responsibilities of the bank, but not those of the client. In the end, the client takes the financial decisions. Hence, the client is obliged to invest efforts to understand the decision problem, to evaluate the advice of the bank and to carefully decide. This raises the question whether a minimal level of financial literacy is required for the client. Rendering advice to someone with little financial knowledge imposes a very high level of responsibility on the bank. If the client has some financial literacy, he should take more responsibility for his choice. Thus, both the bank and the client share responsibilities. The smarter the client, the higher should be his share of responsibility. In other words, the stronger the information asymmetry between the bank and the client, the more responsibility should be imposed on the bank. This motivates our second principle:

Principle B: The bank's responsibility for good client advice is higher, the less financially literate the client is.

There is a potential conflict between Principles A and B. If the bank has more responsibility, advice may be more costly. It may not pay for the client to buy this more expensive advice. To overcome this problem, the bank may reduce its costs by offering the client less sophisticated advice and less sophisticated financial products which he can understand. For example, in the case of very low financial literacy of the client, the bank may standardize its advice by recommending an investment portfolio which combines "risk-free" assets and an exchange traded fund on some market index. In this case, the decision is mainly restricted to the choice of the stock proportion of this portfolio. This stock proportion should increase relative to the risk-taking capacity and the risk appetite of the client. Thus, the cost of advice would be rather low. This type of advice may induce financial decisions of the client which are not in his best interest. But it may allow the bank to earn a competitive rate of return. This illustrates the compromise implied by Principles A and B. A few additional principles will be proposed in section 5.

4.4. Pillar 3: Disclosure for market discipline

Market forces can encourage banks to act in the interest of their clients. The disclosure of information on the quality of the advisory process enables clients to compare banks and vote with their feet. Public

information on a bank's products and services promotes comparability of banks. Today, client satisfaction reports are published, but they are published without mentioning names of banks. Therefore, this information is of little use to clients. It would be much better if the supervisor or some independent agency collected information and published it together with the names of banks.

Collecting and publishing information about the clients' felt quality of retail services might be useful, but it is clearly not sufficient. Banks may frame their interaction so as to make clients feel happy. Yet the service may be quite poor. Therefore, reliable information requires an investigation by an informed independent expert who is able to evaluate the quality of the service. This information would enable clients to effectively compare different banks.

Retail clients in Germany can complain about their bank's service by addressing an ombudsman, the Federal Financial Supervisory Authority (BaFin) or consumer protection agencies. These institutions produce reports when complaints are mounting up. So far, the effect of these reports on retail clients appears to be quite limited.

Another possibility for market discipline can be copied from other industries. Official certification of the quality of the production and servicing process is now quite common in many industries. Banks might also obtain a quality certificate which is renewed regularly. If the banks pay for the certificate, there is a substantial danger of biased certificates. Therefore these certificates can be a supplementary element of Pillar 3 only.²⁵

4.5. The three pillars and misbehavior

How do the pillars address misbehavior exemplified in section 1? The problem of mis-representation of information is addressed in all three pillars. Pillar 1 contains rules for disclosure of information on financial products and services. Pillar 2 should be based on principles which assure that banks provide information which the client comprehends. Pillar 3 reduces information asymmetries between the bank and the client by detailed information on the quality of the banks' service. Yet, mis-representation of information will never be completely removed because of time limits, financial illiteracy of clients and conflicts of interest.

The problem of complex product design is addressed in Pillars 1 and 2. The basic interest of the bank to sell complex products with higher profit margins is addressed by the rule in Pillar 1 that the bank has to inform the client about its margins. It is difficult to regulate the product design because product

²⁵ We do not argue that every bank should subject itself to Pillar 3. Since participation in this pillar is costly and its effectiveness needs to be seen, every bank should decide about its participation. A bank which does not participate sends out a negative signal to customers. That may discourage customers from interacting with this bank.

design may change with financial market conditions. However, financial products are subject to supervisory review (Pillar 2). The supervisor may prohibit the sale of a financial product if it benefits the bank, but not its clients. In other words, if the benefits for the bank are disproportionately strong (the client has to pay for them) relative to the benefits for clients, the supervisor might ban the product. Also Pillar 3 constrains complexity of products if it leads to client dissatisfaction which is communicated to the public.

The problem of non-customized advice is also addressed in all three pillars. Firstly, Pillar 1 sets binding rules for the interaction between the bank and the client, in particular the bank has to collect detailed information about the client. More importantly, a rule should oblige every bank to offer customized advice. Pillar 2 obliges the supervisor to check whether the bank implements this rule satisfactorily. In addition, the regulator and the bank design principles for customized advice and the bank implements them. The supervisor has to check whether customization of advice is sufficient. Pillar 3 makes use of client satisfaction reports and evaluation of bank services by informed experts. If complaints about non-customized advice would be made public, the bank would lose reputation in retail banking and should be motivated by market forces to correct this problem.

5. What are the implications of the three pillars?

In this section we present some implications of our approach for the instruments of client protection, used also by MiFID II and already discussed in section 3. Some of the behavioral requirements proposed by MiFID II should be translated into rules, while others should be translated into principles. In a similar fashion we discuss the implications for compensation of employees, product requirements and disclosure rules. This serves to better explain our approach relative to MiFID.

5.1. Behavioral requirements for banks

A bank employee can only differentiate advice according to the client needs if he knows the client's financial situation, his risk appetite, his risk bearing capacity and his knowledge about financial products, markets and asset allocation. Hence, the MiFID rules asking the bank to collect this information appear necessary. By some principle, the extent to which information is collected should increase with the complexity of strategies and financial products used by the client. A minimum collection should be imposed by a rule.

Negotiation of banks with clients should also be differentiated according to the level of the information asymmetry between the bank and the client, hence to the level of the client's financial literacy. If the client is rather smart, then, according to Principle B, he should take a large share of responsibility in negotiating with the bank. Hence, few behavioral constraints on the bank employee are sufficient. In the case of a rather illiterate client the bank should take a large share of responsibility. As financial

literacy is not easily measurable, principles instead of rules should clearly constrain the discretion of the bank employee in negotiating with the client. The careful employee needs flexibility in dealing with the client. This flexibility should be inversely related to the client's financial literacy.

An additional principle is that the client should understand the financial product which he buys, not in every detail, but with regard to its main features. This is in line with art. 24.5. It will be difficult for the bank employee to check whether the client understands the main features of a financial product. Moreover, the client may believe that he understands the product even though this may not be the case. This problem is always inherent in the advisory process. Part of the responsibility of the client is to ask the employee for a better explanation if he does not understand the product. If he confirms in the consulting protocol by his signature that he understands the product, he cannot make the bank responsible for his own errors and misunderstandings.

The requirement of offering only products which the client understands may be in conflict with basic insights of portfolio theory. Even though the client may have serious difficulties understanding well-diversified exchange traded funds (ETFs) on stock markets, a rule should oblige the employee to offer such funds and explain their basic structure to clients who want to invest in stocks. ETFs combine strong diversification with a risk premium for their systematic risk and low transaction costs. For most stock investors, these funds represent a suitable investment.²⁶

5.2. Compensation of employees

In most industries, sales agents can increase their compensation not only by selling more, but also by selling products with higher profit margins for the employer. MiFID II tries to protect clients against such behavior by the very restrictive art. 24.10.

One way to compromise between the client's and the bank's interest is to return to the conventional system of a custody fee which increases with the value of the client's portfolio. In this case, the employee may get a higher bonus when the value increases. Such a bonus system would destroy the incentives for the employee to sell products with high profit margins, but also his incentives to deal carefully with the client. The employee might want to spend little time with the client by recommending products which require little advice. This applies to low risk-products which today may deliver a negative rate of return. Advice may be minimized or even dropped from the agenda of the bank as suggested by the "advice gap" observed in the UK. This would imply mis-selling.

Therefore, the bank and the employee should have some incentive to spend enough time for effective advice. For wealthy clients, fee-based advice as recommended by MiFID II is clearly an option. Clients

²⁶ Even though ETFs may have some drawbacks, they do not require active trading strategies which are difficult to understand for investors with restricted financial literacy.

with modest wealth tend to shy away from fee-based advice because they may find it too expensive. Moreover, they would have to pay the fee even if they do not buy or sell. A transaction based commission avoids this. How can a transaction based fee be designed to motivate the employee to provide effective advice without taking advantage of the customer's inferior knowledge?

A compromise likely requires (1) differentiated transaction fees and (2) joint action of the client and the employee. (1) As more complex products require more advice and, thus, are more costly for the bank, the client's transaction cost should be higher for more complex product groups. The transaction cost should cover the expected cost of advice as well as the cost of order execution and allow the bank to earn the cost of capital. (2) In order to constrain the employee, the client should decide for which product group he wants advice when he contacts the bank. This decision making process would be simplified if the bank not only defines for each product a suitable client group, but also for each client group a set of suitable products. Since the client chooses the product group, the employee may select products with high bank margins within this product group. If, however, the transaction cost is similar for products within one product group, the opportunities for the employee to take advantage of the client's illiteracy are extremely limited. This approach requires the client to interfere in the negotiation process. The client with little knowledge of financial products and markets may limit the scope of advice to less complex product groups while the smarter client may prefer more complex product groups. This does not rule out that a smarter client sometimes may prefer less complex products. Thus, clients should self-select into different product groups.

Without an active role of the client, it will be very difficult to deal with the conflict of interest between the client and the bank in a satisfactory manner. In a game in which one player is completely passive, the other player can easily exploit the situation for his own benefit. His effort will be minimal if his reward needs to be independent of effort. Better solutions can only be obtained if both players interact. This is also in line with Principles A and B, but inconsistent with art. 24.

Also, there should be a default option for all transactions: Whenever the client knows precisely what to buy or sell, he gives a precise order to the bank. The bank executes the order without advice (execution only) and cannot be made reliable for this transaction. In this case, the transaction costs for the client should be low. This would motivate him to learn in order to lower his transaction costs.

The bank should retain the competence and responsibility for the design of the compensation system. It might include a bonus to motivate the employee to deal carefully with the client. To permit a judicial review of advice, a consulting protocol is necessary. In addition, the protocol might help the client to better understand the pros and cons of his transactions. Such a protocol is required in Germany according to § 34 Wertpapierhandelsgesetz. In MiFID II, the "statement of suitability" may be comparable to the consulting protocol.

5.3. Product requirements

Talking about “simple” and “complex” financial products requires some characterization of complexity. There is no clear definition of complexity. A starting point could be a regression which explains the return of a financial product as a function of different risk factors. One criterion for ranking the complexity of a financial product is the number of relevant risk factors and their pricing. Non-linearities of the product payoff in risk factors add to the complexity. The choice of risk factors is arbitrary to some extent, however. Therefore, principles for product requirements are preferable to rules.

As an example, consider a corporate stock. One may write the stock return as a linear regression of the market return, the return of the industry in which this corporation operates, and a corporate specific risk factor. Compare this corporate stock with an ETF on a market index. Its return is, by definition, equal to the market return. Hence, one may argue that the market index is driven by a single risk factor. Therefore, the market index may be considered a simpler financial product than a corporate stock. This is likely the perception of a client who understands portfolio theory. Also, it is easier to predict the market return than the return of a single stock.

For a financially less informed client, this perception may be counterintuitive because he may define the return of a single stock as a risk factor so that a single stock is a simple financial product. In his perception, the return of the market index is driven by the returns of all stocks included in the index. Analyzing all stock returns and their statistical dependences renders the ETF a complex product for an unsophisticated client.

What should the bank employee do? He might teach the client the basics of portfolio management and then sell him an ETF. This teaching might be time consuming and fail in the end. The client may still prefer a single stock. As the client decides (unless he delegates portfolio management to the bank), it cannot be the duty of the employee to prevent the client from taking a poor decision. Instead of urging the employee to prohibit the client from taking a poor decision, the regulator should obligate the employee to inform the client when he takes a decision which a “rational” investor would never take. In particular, the employee should be obliged to inform the client if he takes a risk which raises his portfolio risk substantially, but does not earn him a risk premium. As “substantial” and “risk premium” involve subjective perceptions, we suggest a principle instead of a rule.

Principle C: The employee should not recommend a financial product to a client if it raises his portfolio risk, but cannot be expected to earn a risk premium.

Hence bank employees should not recommend a financial product if it imposes a substantial idiosyncratic risk on the client which is not positively priced. Also, they should warn the client if he wants to buy a product with such a risk. For illustration, consider a bond with an interest rate, which might

change depending on the outcome of some lottery. Usually, the lottery risk is not priced, i.e. it does not earn a risk premium. Therefore, the bank employee should not recommend this bond. Or compare an equity linked bond (= a bond combined with an option on a single stock), and a bond combined with an option on some stock index. As a stock option also involves an idiosyncratic stock risk which likely is not priced, an index option is to be preferred according to Principle C (unless the stock option in the bond serves to hedge this risk inherent in another position of the client's portfolio). As a more complicated example, consider an internationally diversified stock/bond portfolio. Even though a pure exchange rate risk usually does not earn a risk premium, the overall portfolio risk may be reduced by international diversification so that it is "rational" to take the "non-priced" exchange rate risk. Many clients, however, will face substantial difficulties understanding these portfolio effects. Therefore such products should be offered only to sophisticated clients as an appropriate target group.

5.4. Disclosure rules

As summarized in section 2.4., MiFID II imposes far reaching disclosure requirements on investment firms. We endorse the MiFID II transparency rules on the transaction costs of financial products and potential conflicts of interests in offering financial products, for example due to kick-backs, i.e. payments of a third party to the bank for selling a particular financial product (art. 24.7, 24.8). This is mostly standardized information which does not need to be differentiated to client groups and can be published at low cost by the bank.

More controversial is the written information which banks need to publish about the offered products. MiFID II (art. 24.4) and the German Wertpapierhandelsgesetz (§ 31 (3), (3a)) require banks to publish written information in standardized form on financial products, in particular on all their risks and costs, and on proposed asset allocation strategies. This information is not differentiated according to the client's level of financial literacy, but should be (easily) comprehensible for all clients. This requirement appears completely unrealistic since financially illiterate clients have little chance to understand such product information.

To keep the information leaflet readable, it needs to be condensed to a few pages. This may be effective for an advanced client, but hardly for a client with little financial literacy. To make it digestible for such a client, the leaflet needs to concentrate on a few "simple" characteristics of the product and the allocation strategy. But this puts the investment firm at the risk of mis-information. A very detailed information leaflet may be too complex for the non-sophisticated client. A possible way out of this dilemma is a combination of information leaflets and personal advice which is differentiated according to the client's level of financial literacy. The leaflet together with the documented personal advice needs to be detailed enough to protect the investment firm against being sued for information gaps,

but it also needs to be understandable. The alternative of not publishing any written product information appears unacceptable because every company is obliged to inform its clients about its products. Otherwise a client cannot take an informed decision even though his understanding may still be poor.

Regarding asset allocation strategies, it will be impossible to discuss their pros and cons in detail in such a leaflet because their risks can only be evaluated with respect to the particular financial situation of the client. This suggests that again both, the leaflet *and* personal advice, are necessary to inform the client, taking into account his financial literacy. Simple rules alone cannot prescribe appropriate disclosure for all client groups and therefore principles are necessary as well.

5.5. Combining different instruments for client protection

So far, these four key instruments of client protection have been discussed mostly in isolation. Also the MiFID II rules on each of these instruments appear to be set independently of the rules on the other instruments. But it makes little sense to decide about these instruments separately because of synergy effects between them. In addition, instruments for client protection are not dichotomous (0,1)-variables, but they can be varied on a continuous scale so that the intensity of client protection also varies. Should every protection instrument be used at its level set by MiFID II? The answer is clearly no. There are two reasons for this. Firstly, taking an instrument to its limit does not necessarily maximize client protection. Consider, for example, the consulting protocol. This can be written in a very detailed manner making it quite expensive. Moreover, too much detail may confuse the client so that he attaches too little weight to the main aspects of the decision to be taken. Thus, beyond some point, more detail might lower the benefit for some client, besides of the additional cost of writing. Hence, there exists an interior optimum of details.

Secondly, the marginal protection benefit of one instrument likely depends on the level of other instruments. As an analogy, consider the safety standards for driving cars. The marginal safety benefit of lowering speed limits is smaller when the technical safety of cars is higher. For our purposes consider the compensation system for bank employees. If the employee gets a bonus for transactions of his retail clients, then a higher profit participation rate might induce the employee to recommend the client a transaction which is not in his interest, but earns the bank a higher profit.²⁷ This is less dangerous for the client if he has precise information on profit margins of different financial products. Then, if he is smart enough, he anticipates the employee's behavior and takes it into consideration in decision-making. Hence, a higher participation rate may be tolerable if the bank discloses more information on conflicts of interest. Similarly, stricter constraints on the behavior of employees may allow for a

²⁷ The profit participation rate is defined as the share of the bank's profit margin paid out as a bonus to the employee.

higher participation rate. If, for example, the set of financial products which the employee can offer to the client excludes structured finance products with high profit margins, the employee cannot take advantage of the client through selling these products. Thus, a higher participation rate is less dangerous for the client.

These examples illustrate substitution effects between different client protection instruments. Since these instruments are costly, the desirable levels of these instruments cannot be determined independently from each other. The bank faces the problem of determining an optimal portfolio of different protection instruments such that the marginal cost of each instrument equals its marginal protection benefit. A system which advocates a high protection level of each instrument implies a waste of money.

The optimal intensity of protection also depends on the client's level of financial literacy and his efforts in decision-making. As a smarter client is better protected and, by Principle B, should take a higher share of responsibility, the optimal intensity of protection is lower. Hence, a bank may implement different portfolios of protection instruments for different clients groups with different levels of financial literacy. This is fairly complicated and clearly a topic for the supervisory review process.

Banks should have the right to decide on the protection instruments taking into account their clients' financial literacy. As the socially preferred interaction between a bank and its retail client involves many uncertainties, the bank should start a learning process and gradually improve the interaction. Once an effective interaction process is reliably known, it may be anchored in some rules.

5.6. Caveats

An important caveat regarding bank regulation is the need for a clear definition of mis-selling. The paper discusses three types of mis-selling, driven by the information asymmetries between the bank and the client. In practice, however, mis-selling might be confused with an unfortunate realization of some risk factors, for example a stock market crash. Irrespective of the bank's information about the risks of a financial product, bad realizations always occur. Clients need to be protected against *ex ante* mis-selling, but nobody can protect them against *bad realizations* of risk factors. It is therefore important to design a regulatory system which prevents *ex ante* mis-selling, but also acknowledges that not all client complaints are well grounded in bad bank behavior. Also, if clients entrust asset management to banks, then banks take risks on behalf of the clients and should not be accountable for future losses if the management was done carefully and fitted the needs of the clients. Finally, if a client insists on some bad financial choice despite of warnings of the bank employee, then the bank cannot be made responsible.

A second caveat relates to the material content of the client's interests. To what extent should the smarter adviser insist on his ideas for an investment strategy, to what extent should he listen to the client? Mullainathan, Noeth and Schoar (2012) run a mystery shopping experiment in the U.S. to test how investment advisers reacted to clients at the first encounter.²⁸ They found that at the first meeting advisers did not risk arguing against potential client misperceptions. Rather than mitigating potential errors, they could even amplify biases and misperceptions. On the other hand, advisers often follow their own preferences and beliefs. Foerster et al. (2016) (see footnote 18) find that advisers exert substantial influence over the client's asset allocation, but provide limited customization. Anagol, Cole and Sarkar (2013) (see footnote 12) find that advisers catered to the beliefs of uninformed clients even if these were wrong. These examples illustrate a dilemma of the adviser. On the one hand, the paternalistic view holds that the adviser should have a strong impact on the investment policy of the client since he knows better. On the other hand, the client has to take the final decision and therefore should be free to follow his own ideas. When does the adviser act in the best interest of the client? It is very difficult to give a clear-cut answer to this question. The borderline between neglecting the "best interest" of the client and mis-selling is not obvious in these examples.

6. Conclusion

Retail banking is a service industry plagued by strong heterogeneity of clients in terms of their financial literacy. As banks are financially more sophisticated than clients, clients should be protected against mis-selling by bank employees/retail advisers. MiFID II represents an important step forward to protect clients, but it also proposes many strict rules which impose high costs and low revenues on banks and ignore heterogeneity of retail clients. Thus, MiFID II may destroy incentives for banks to provide valuable service to different client groups and thereby endangers healthy competition among banks. In order to avoid these shortcomings, this paper suggests a different approach to protect retail clients. The translation of MiFID II rules into a three pillar approach with more principles and fewer rules, as proposed in this paper, should protect clients more effectively, lower banks' costs and raise their revenues so as to enable them to earn the competitive cost of capital. This approach seeks to find a fair balance between the conflicting interests of banks and clients.

The reassignment of the MiFID II rules into rules and principles and the monitoring of their implementation require supervision by an independent supervisor. He should check the implementation of rules and principles by banks, preserving their flexibility in designing its interaction with heterogeneous retail clients. This should enable the bank to improve their interaction with clients in a learning process, to differentiate interaction with clients according to their level of financial literacy and, thus, provide

²⁸ Mullainathan, S., M. Noeth, A. Schoar (2012): The Market for Financial Advice: An Audit Study, *Quarterly Journal of Economics* 102, 179-222.

valuable service to all clients. Also, this approach attempts to motivate clients to take an active role in their interaction with banks and to improve their financial literacy. Both, on the European and on the national level, it is crucial that the forthcoming regulation combines supervision and market mechanisms to fulfill private clients' needs including their fair treatment and to ensure competition between banks. Improving retail banking will be an ongoing challenge for regulators, supervisors and banks.