A changing investors/ intermediary relationship

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A dual complex relationship: consumers

- In the **eyes of individuals** financial institutions and markets have become more complex:
  - Many more products
  - Many more complex financial products
  - More difficult contracts to understand
  - More intricate interactions

Complexity has gone up, ability to grasp and understand not as much

A dual complex relation: intermediaries

- In the **eyes of financial institutions** customers have become more complex to deal with:
  - More demanding
  - More volatile and behaviour harder to predict
  - More heterogeneous: in preferences, in beliefs, in needs and in endowment
    - *Harder to fit with appropriate products*

Intermediaries (and firms more generally) **capability to deal with customers is continuously challenged**

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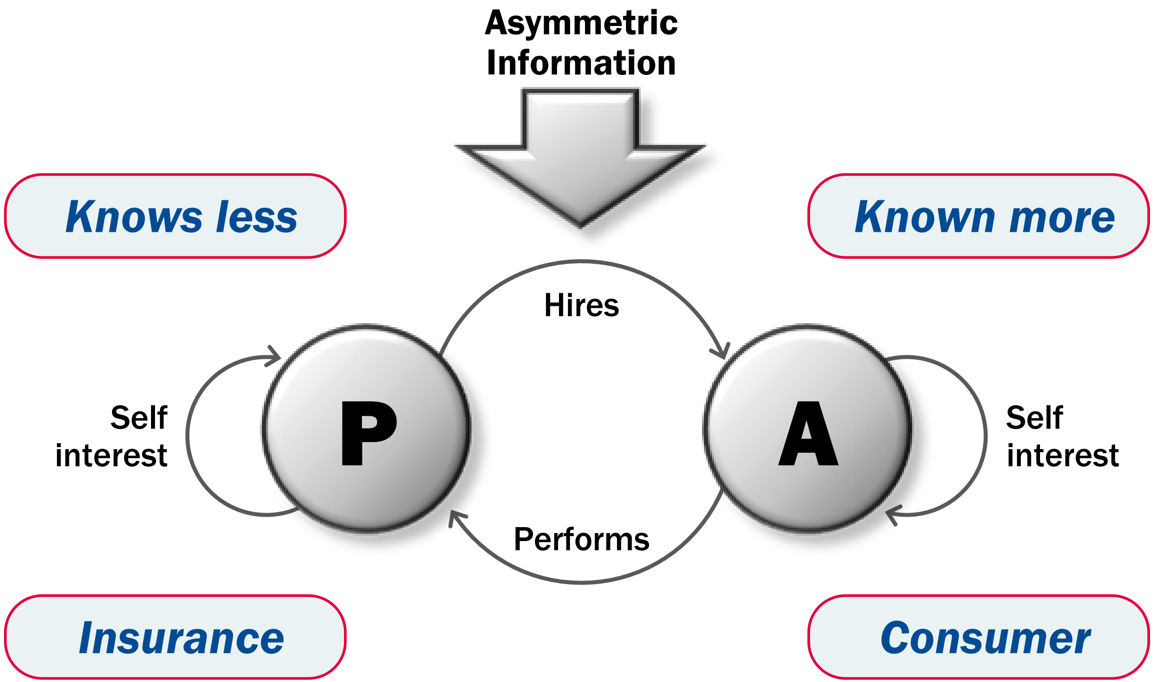
Proximate causes

- **Most important:** the change in availability and distribution of information induced by the ICT revolution
- **Immediate implication:** a change in the nature of the relation between customers and intermediaries

Focus: look at two dimensions of this change

1. **The reversal of the traditional model of asymmetric information**
2. **The increased exposure to reputation spillovers**

The Asymmetric Information Reversal



The Asymmetric Information Reversal

- Modern data gathering technologies **can reverse this situation**
  - → Example 1: Because a cell phone provider keeps and analyses detailed records, he may know consumer expected usage more than the consumer himself
  - → Example 2: A credit card company may know more about the probability of a consumer incurring a late fee than the consumer himself
  - → Example 3: An insurance company may know more about the risks faced by a firm entering a new market than the firm itself

Is this for real?

- Observing the pattern of purchases of its customers Target can detect pregnancy at early stage
- **Highly valuable in marketing:** pregnancy is when women can more easily switch consumption habits

Forbes

Kashmir Hill, Forbes Staff

Welcome to The Not-So Private Parts where technology & privacy collide

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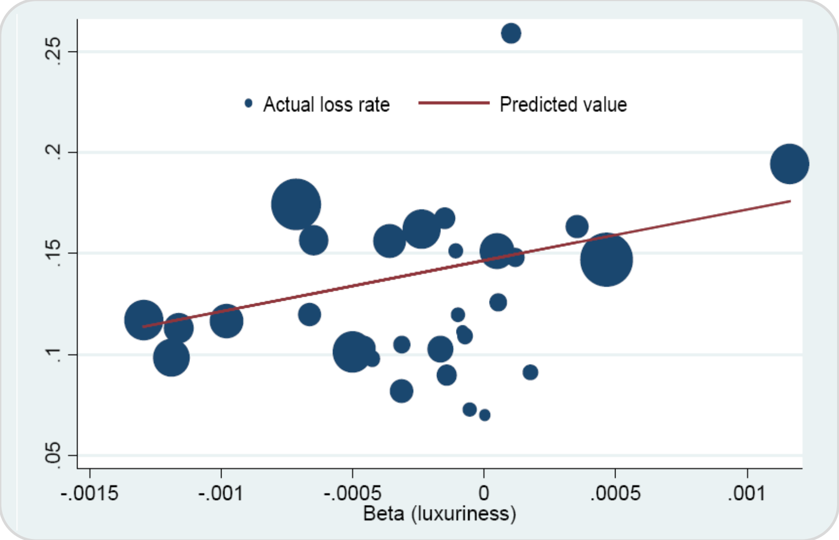
TECH | 2/16/2012 @ 11:02AM | 1,515,636 views

How Target Figured Out A Teen Girl Was Pregnant Before Her Father Did

Is this for real?

- What you buy may reveal your default probability
- Purchasers of luxury goods more likely to default
- Info valuable to firms, **but also** to consumers if default is costly

LOSS RATE



Share of Luxury Goods

This poses new questions

- How can firms use this information advantage?
- Would customers benefit from information revelation?
- Are there incentives to reveal the information to customers?
  - → Will firms do it voluntarily?
  - → Will the market do it?
  - → Is there scope for regulation to force it?

Firms use of informational advantage

- Information can be used to improve targeting of products to customers. Two types:

A. Favorable targeting:

e.g. **books proposals on Amazon**: when you search for a book you get suggestions about related topics

firm processes information on your preferences easing your search

B. Adverse targeting:

1. A credit card company that figured out you are absent minded, can offer a "free" card and make money on your late fees
2. A casino can send ads targeting people they know suffer from addiction inferring this from patterns of consumption (MIT economist)

Seller and buyer incentives are aligned in A not in B; it is this second case that attracts attention

Can customers benefit from revelation?

- *In general yes*: if information on pricing and usage is revealed a customer reacts to this information re-optimizing
- **Effects can be sizeable:** in a field experiment on US health insurance, revelation of plan costs based on past drug utilization

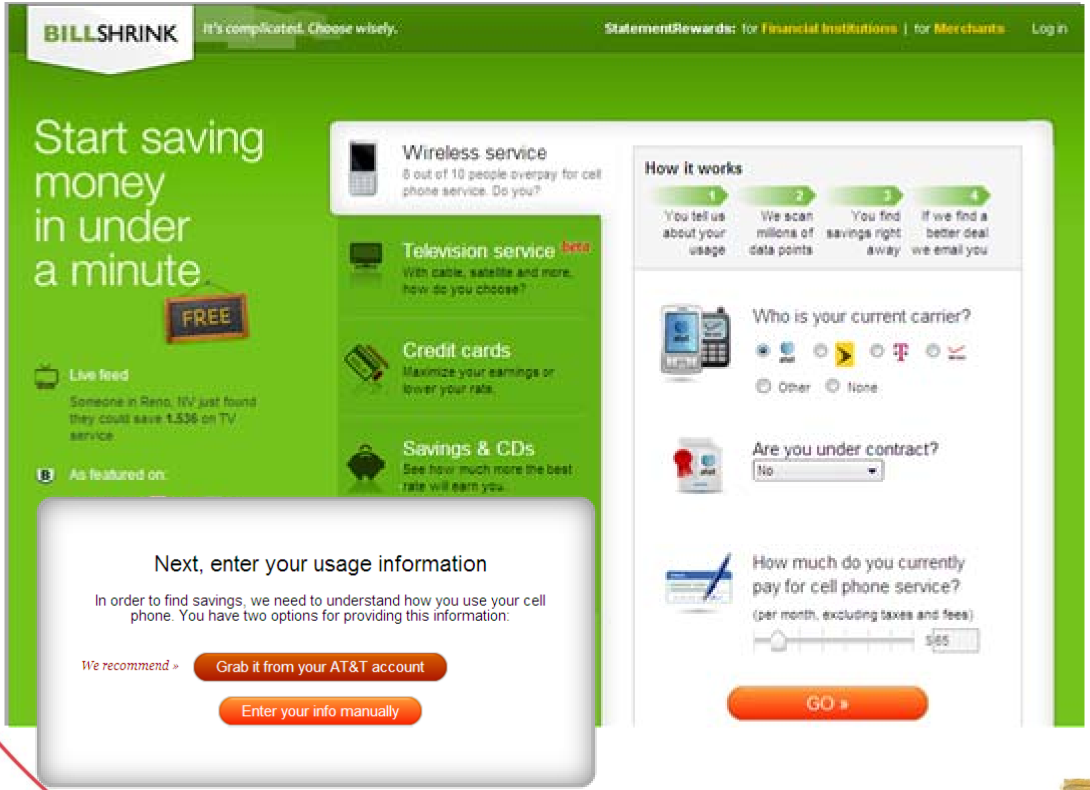
Plan switching rate went up by 20%
Expenditure went down by 14%
▶ **Hence consumers benefit unambiguously**

- But this is true **if market prices are held constant**
- Prices may **actually increase** if revelation policies are imposed (Kamenica, Mullainathan and Thaler, 2011) ▶ dampens benefit

Are there incentives to reveal information?

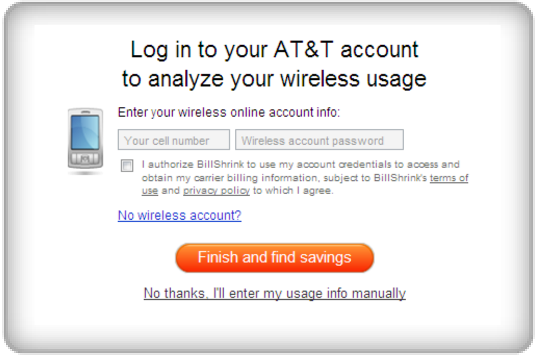
- In the case of **favorable targeting** obviously yes
  - firms gain from revealing information (e.g. Amazon)
  - will reveal voluntarily
- When information advantage leads to **adverse targeting** no because the firm may lose profits
- In such a case firms will oppose any attempt to bridge the information gap

Can the market do it?



- **Billshrink** is an example of emergence of third parties to bridge the information gap :

can scrape the data from the customer provider and do the calculations for him about best alternatives



A few summary thoughts

- Today a firm may end up knowing more about the consumer than the consumer himself
- Creates incentives to obtain, exploit and **not** disclose this information
  - On Innocentive a call for ideas to identify private information on the web L
- But also incentives to invent strategies to pass the information back to consumers
  - A call for ideas to provide "Smart Disclosure Policies" L

Trust, Fragility and Intermediaries Reputation

The importance of trust

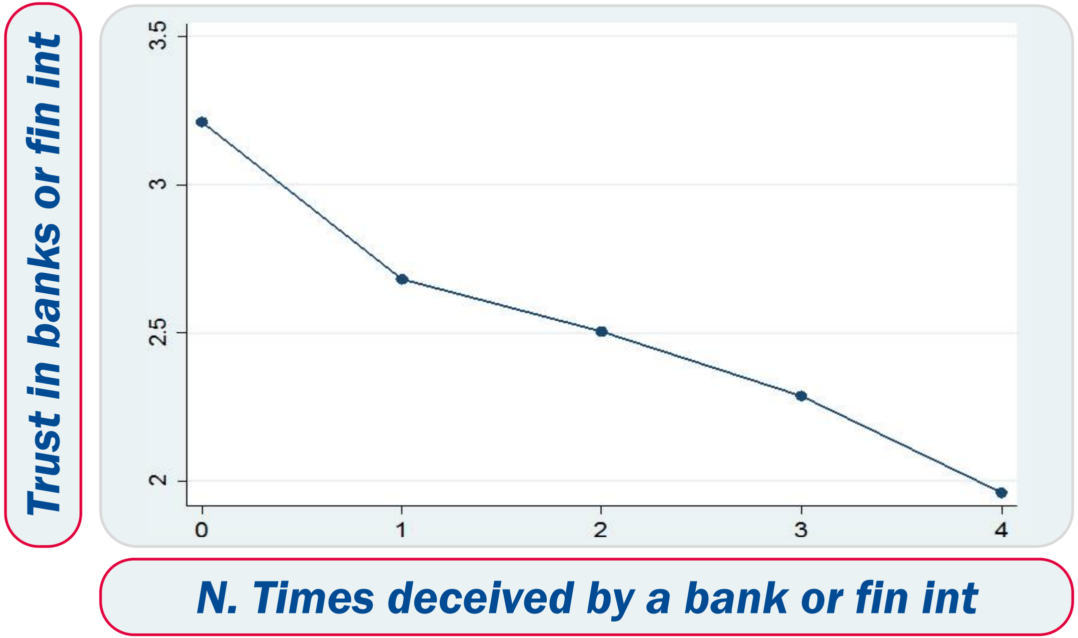
- Trust important in most transactions but key in financial markets
- All financial transactions entail an exchange of money today against **a promise** of (more) money in the future
- What sustains that promise and thus allows the exchange to carry over is the trust

Point: **consumers' trust towards their insurance company may be affected by facts that bear no direct link to the company nor to insurance**

Trust Spillovers

- **Idea**: if a person is deceived by his neighbor, he is going to lose faith in him
- Is he also going to lose faith with the other neighbors?
  If yes, trust spills over
- Critical in financial markets: you may lose your reputation **not** because **you** misbehave but because your “neighbor” misbehaved
- But while you have control over your own behaviour your have little control over your “neighbors”

If an individual is deceived by a *bank* he/she loses trust in *banks*



- Those cheated multiple times have an average trust towards financial intermediaries 1/3 lower than those never cheated

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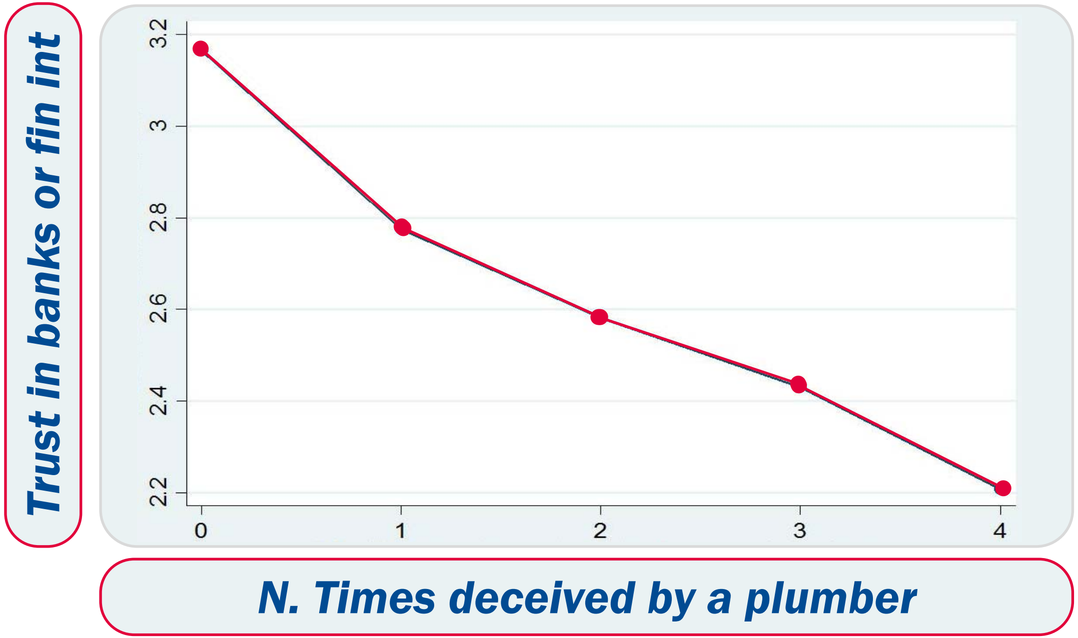
But he/she also loses trust in *banks* if he/she is deceived by a *plumber*

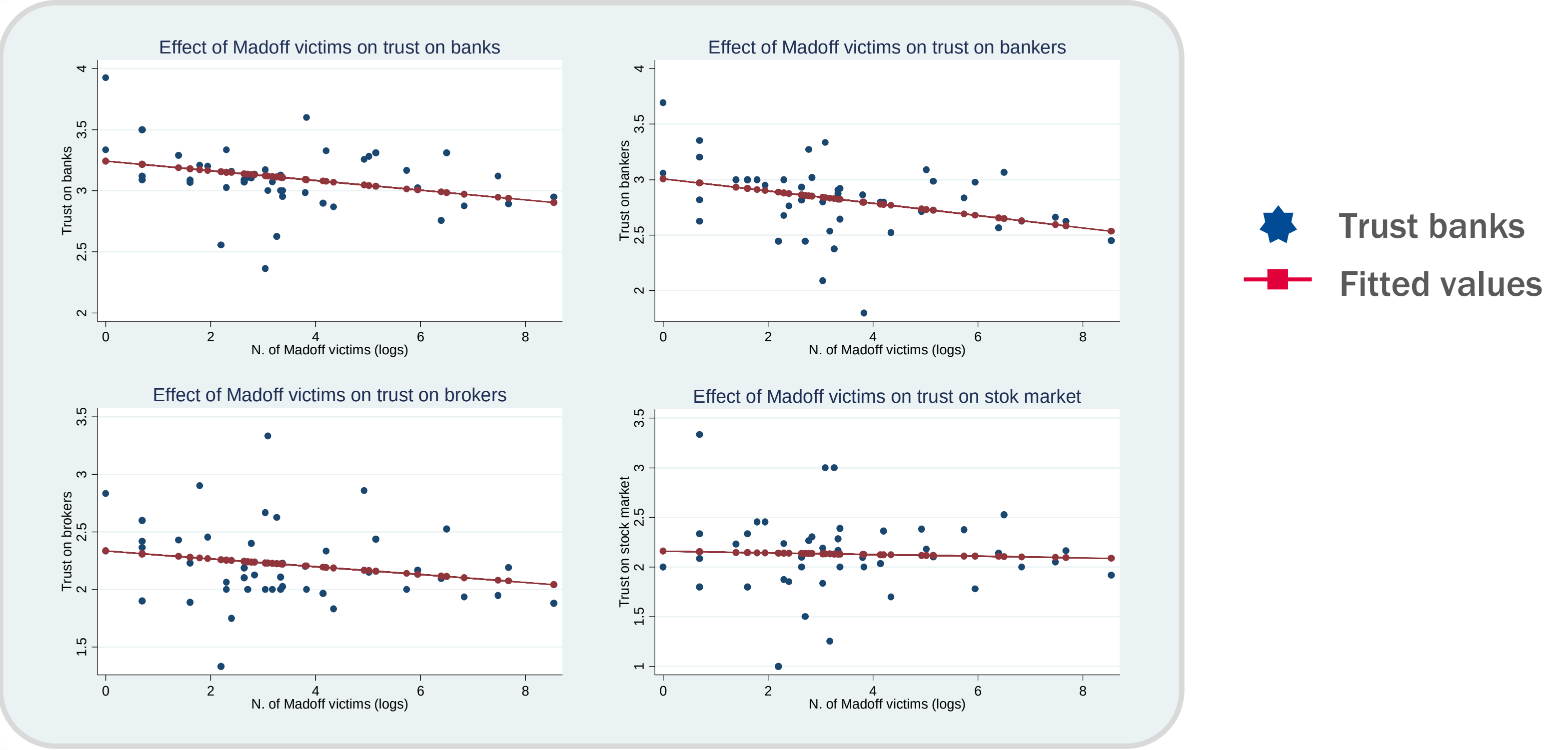


- And the vice versa is also true.

Spillovers during the crisis

- Among other things, the crisis brought to light diffuse opportunistic behaviours and some serious frauds
- The emergence of Madoff's fraud has undermined confidence not only of the direct victims, but of investors in general
- This, in turn, has spilled over to the whole industry

Madoff's victims concentration and trust spillovers



Reputation spillovers are not new…

- The famous 1907 New York panic started when it became known that that Charles T. Barney, president of Knickerbocker Trust was involved in earlier businesses dealings with Charles W. Morse who was involved in a scandal (Frydman, 2012)
- On October 21, depositors run on Knickerbocker Trust, which closes its doors
- All trusts whose board members are linked to Barney are run and panic spreads across all New York Trusts
- Loss of reputation led to the panic, all trust company were solvent


The World
FINAL
FINAL RESULTS EDITION
ALL TRUST CO. HEADS CONFER AFTER KNICKERBOCKER CRASH
PANIC OR NO PANIC, ROOSEVELT STANDS BY HIS POLICIES
FAVORITES LOSE; UGLY TALK HEARD AT RACETRACK
$6,000,000 FAILURE ON STOCK EXCHANGE; MAYER & CO. ASSIGN

Two key features

1. Geographical proximity
2. Direct connections

... But today they are faster, broader and indirect

- Because of widespread access to the internet information spillovers:
  - → Can spread faster
  - → Are geographically unbounded
  - → Affect millions of people
  - → Can quickly affect unrelated agents and companies

Example from the crisis

- In California, right after Madoff's scandal, investors at Cascade Acceptance - a private fund - claimed their money back immediately

    - **Fund closed**

→ Geographically far away from Madoff's center of activity

→ No direct link except that the fund owner was Jewish like Madoff. This was the only analogy

Even behaviour that is not scandalous where it is produced can affect reputation elsewhere

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Insurance firm Munich Re's Ergo divison rewarded workers with prostitutes at a Budapest spa

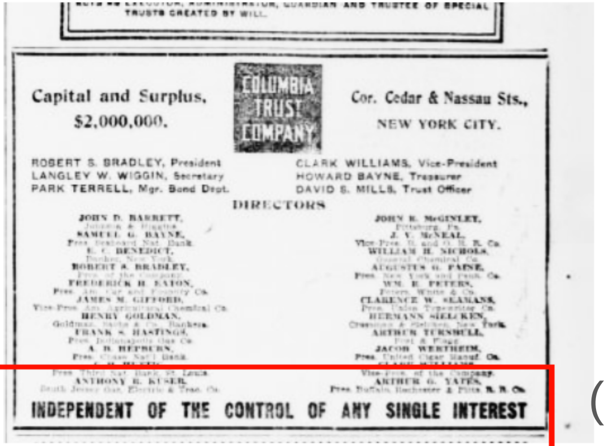
The Daily Telegraph May 22, 2011 7:15PM 4 comments

Recommend | Send | 118 people recommend this.

theTelegraph

… Reacting to the threat of loss of reputation after the fact may be too late

New York Tribune Oct 24


Capital and Surplus, $2,000,000.

COLUMBIA TRUST COMPANY

Cor. Cedar & Nassau Sts., NEW YORK CITY.

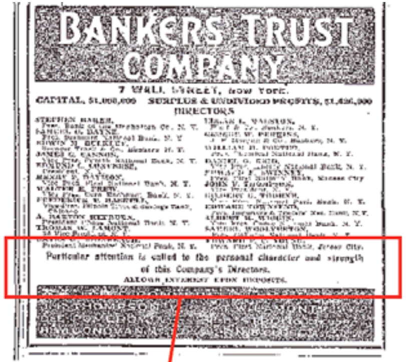
ROBERT S. BRADLEY, President
LANGLEY W. WIGGIN, Secretary
PARK TERRELL, Mgr. Bond Dept.
CLARK WILLIAMS, Vice-President
HOWARD BAYNE, Treasurer
DAVID S. MILLS, Trust Officer

DIRECTORS

INDEPENDENT OF THE CONTROL OF ANY SINGLE INTEREST

(Frydman, 2012)

New York Times, Oct 24, Oct 25, 1907


BANKERS TRUST COMPANY

7 WALL STREET, NEW YORK.

DIRECTORS

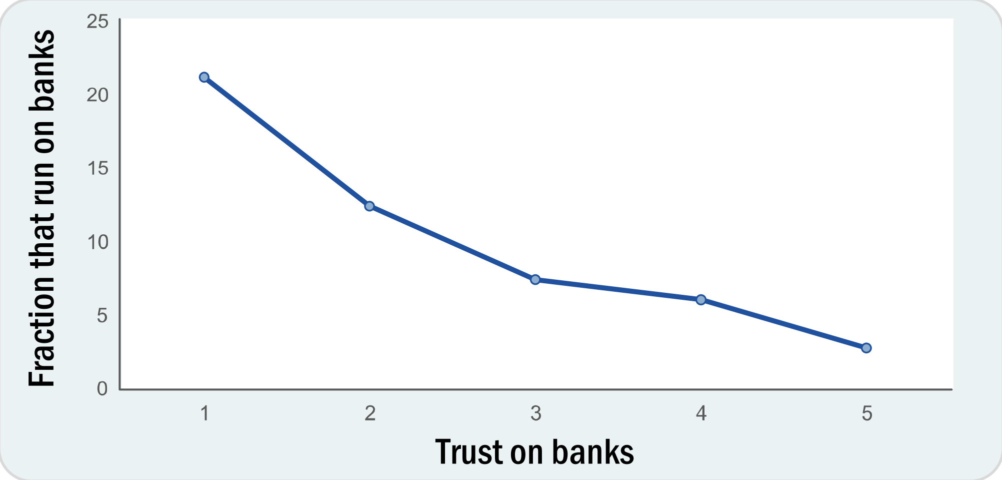
Particular attention is called to the personal character and strength of this Company's Directors.

"Particular attention is called to the personal character and strength of the company's directors."

Better to act before.
But how, given that reputation spillovers are very hard to predict?

... Building trust makes one robust to losses of reputation

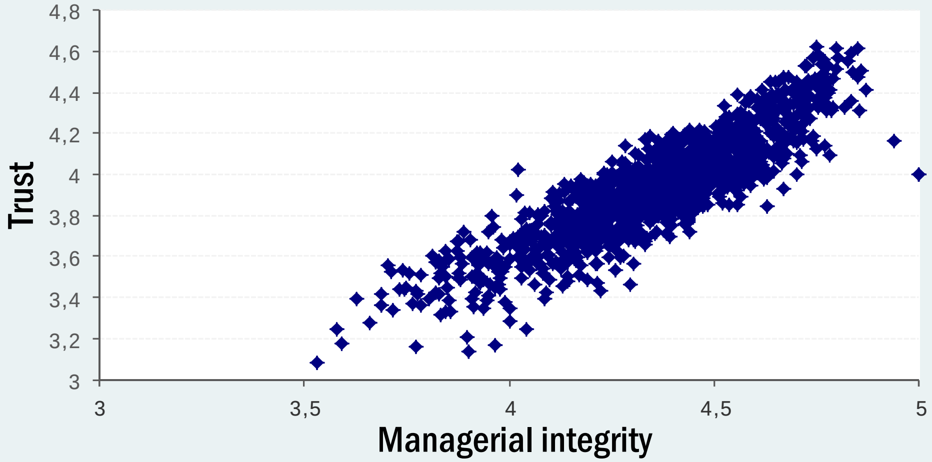
Effects of trust on banks on decision to run



- Bank customers that before the crisis had very high trust in their banks were much less likely to run

How can one foster and maintain trust?

Trust and integrity



- A strong corporate culture of integrity and promotion of ethical behaviour builds and preserves trust in the corporation