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Conflicts of interest, information provision, and competition in the financial services industry ☆

Patrick Bolton[a,*], Xavier Freixas[b], Joel Shapiro[b]

[a]*Columbia University, 804 Uris Hall, New York, NY 10027, USA*
[b]*Universitat Pompeu Fabra, Ramon Trias Fargas 25-27, 08005 Barcelona, Spain*

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Abstract

In some markets sellers have better information than buyers over which products best serve a buyer's needs. Depending on the market structure, this may lead to conflicts of interest in the provision of information by sellers. This paper studies this issue in the market for financial services. The analysis presents a new model of competition between banks, where price competition influences the ensuing incentives for truthful information revelation. We also compare conflicts of interest in two different firm structures, specialized banking and one-stop banking.
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*Corresponding author. Fax: +1 212 662 8474.
E-mail address: pb2208@columbia.edu (P. Bolton).

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1. Introduction

This paper examines the provision of information by sellers of financial services to customers. The issue of information provision is timely, as the banking industry evolves from the traditional business of financial intermediation towards a fee-based industry in which information is crucial in providing customers more added value. In a departure from the standard finance literature, we make the assumption that some investors are partially uninformed in the sense that they don't know which financial product best suits their needs. This assumption allows us to model a basic conflict of interest problem in the financial industry that may give rise to the misselling of financial products: should a financial intermediary tell a client that another firm offers a product that better suits the client's needs, or should it try to steer the client to one of its own products? This conflict of interest problem in providing advice to clients has prompted many commentators to advocate the separation of information provision from the sale of financial products. Our results, however, directly challenge the conventional wisdom that information is only credible if it is provided by an independent institution that has no such conflict of interest. Indeed, we find that in various market environments, competition or consolidation (into one-stop banks) can resolve this conflict of interest.

In our basic setup customers do not know which financial product best suits their needs, but financial institutions (who sell some of these products) may be able to provide this information to customers. We assume that information is nonverifiable but that financial institutions suffer reputation costs for misselling. In a heavily regulated environment such as that of financial services, the disclosure of verifiable information can be made compulsory and any attempt to falsify the information can be heavily penalized. However, the issue of inducing revelation of nonverifiable information remains. But, since financial institutions often care about maintaining their relationships with their clients, some discipline in the revelation of nonverifiable information can be imposed through reputation costs for giving misleading advice.

Although our research is primarily motivated by issues relevant to the financial services industry, our findings apply to any market in which buyers are uncertain about which product is best for them and sellers face a reputation cost if they provide misleading information. Examples of such markets outside the finance industry might include the market for medical procedures, the market for real estate, and the market for sophisticated technical equipment.

Our main findings are as follows. Competition among specialized financial intermediaries can lead to full credible information disclosure, even in the presence of only small reputation costs. The basic intuition for this result is that competition both reduces the gains from lying and induces financial institutions to disclose information in order to differentiate their products and thus relax price competition. By credibly disclosing information financial institutions can restore their margins on a smaller base of customers that have special needs. However, the size of potential reputation costs limits profit margins because with high profit margins the advice provided to clients is no longer credible. As a consequence, sellers could still gain from the presence of a third party (such as an independent financial advisor) that provides information, allowing them to raise margins further.

One-stop banks, defined here as banks that sell multiple products, can also overcome this conflict of interest in certain circumstances. While the creation of one-stop banks is

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