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Impact of Information Disclosure on Consumer Behaviour[1]

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Summary:

Mis-selling by financial service providers poses a grave threat to consumer protection. This can adversely affect the financial well-being of consumers. Mandating information disclosures in order to bridge the information asymmetry between financial service providers and consumers is one concrete way to curb mis-sale and improve consumer outcomes. Our recent working paper report results from an experimental study that examines the impact of information disclosure on consumers' purchase decision of a high-risk financial product. We randomly assign two variations of information disclosure among the study respondents- one that is accurate, highlighting both the risks and returns of the product and the other that is inaccurate, focusing prominently on the potential gains from the product. We then examine the differences in purchase decision based on the disclosure type the respondents receivedand find that the odds of buying the high-risk financial product are 80 to 90% lower when the disclosure type is switched from inaccurate to accurate. The results of our study indicate that disclosures can have substantial impact in altering consumer's decisions against welfare reducing outcomes. Therefore, in this policy brief, we provide our recommendations to enhance information disclosure.

About Household Finance Research Initiative:

The Household Finance Research Initiative focuses on two broad themes. The first aims to generate a richer understanding of the goals and opportunities that households face in their financial lives and their use of financial and non-financial strategies to achieve these goals. The cumulative outcomes of these strategies or the results from the interaction of poorly designed or unsuitably delivered market-prevalent financial products can lead to sub-optimal portfolio allocations for households, also known as 'financial mistakes'. Our second research theme aims to unpack the complex interaction of demand and supply factors that result in these mistakes and to inform product design improvements or policy initiatives to minimize their incidence as well as mitigate their harmful consequences for vulnerable households.

[1] This policy brief is based on Dvara Research Working Paper on Impact of Information Disclosure on Consumer Behaviour. See here

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Problem Statement

In the financial services industry, a variety of threats to consumer protection exist such as mis-selling of unsuitable financial products and services, lack of adequate grievance redressal mechanisms and data protection, and privacy concerns, due to the rapid rise of digital financial services, among many others. As per the economic literature, mis-sale is usually driven by a conflict of interest in the distribution of financial products and information asymmetry due to imperfect disclosure of information (Mullainathan, Noeth, and Schoar, 2012; Beyer, de Meza, and Reyniers, 2013)[3]. In India, there have been multiple incidents of mis-sale of financial products. These typically involve a distribution agent recommending or selling a financial product that fetches high commissions for the agent but is not well suited to the financial needs and requirements of the customer, potentially causing harm to the financial health of the consumer. One way to reduce information asymmetry and encourage informed decision making by the consumers is by mandating transparent, accurate, complete, and comprehensible disclosure of information.

Economic theory argues that information asymmetry between buyers and sellers is a market failure that leads to suboptimal outcomes for the party having lesser information (Milgrom, 2008)[4]. Suboptimal outcomes for consumers happen when sellers are selective with the information they disclose to the consumer and buyers do not possess enough knowledge to ask relevant questions. This makes a clear case for regulatory intervention to address this market failure and ensure that consumers are protected against such outcomes. While regulators do mandate disclosure of accurate information by financial firms, few regulators clearly specify the standard of accuracy that is required for consumer protection. Even where standards do exist, regulatory supervision is found lacking. Besides, while disclosures can help reduce information asymmetry, it is not entirely clear how they impact consumer behaviour.

Context Setting

In recent times, one such incidence of mis-sale that has come to light in the Indian financial services industry is the case of Additional Tier 1 (AT1) bonds. AT1 bonds are perpetual debt instruments issued by banks as part of their regulatory capital requirement. These bonds are treated as quasi-equity and have no specified maturity date. The most pertinent feature of these debt instruments is that the interest and the principal on these bonds need not be returned to the investor but can rather be extinguished, partially or fully, at the discretion of the bank and the RBI. This is the main reason that these bonds are treated as quasi-equity and are also considered to be riskier debt instruments than plain vanilla bonds, debentures, and fixed deposits. Consequently, AT1 bonds are priced higher than other debt instruments of similar maturity.

Last year several stories appeared in the media wherein retail investors lost their entire investment into AT1 bonds, particularly those offered by a large, private commercial bank. High-net worth individuals and urban retail investors were mis-sold these bonds with partial and inaccurate information about the risks and returns associated with them. In addition, investors of AT1 bonds who experienced a complete loss of their investments were left with little to no opportunity for meaningful grievance redressal. The Reserve Bank of India (RBI) also squarely put the onus of undertaking a high-risk financial decision on the consumer, thereby defaulting to a stance of caveat emptor wherein the burden of selecting a suitable product and making an informed choice/decision fell solely on the consumer.

[3] See here for (Mullainathan, Noeth, and Schoar, 2012); See here for (Beyer, de Meza, and Reyniers, 2013)
[4] See here for (Milgrom, 2008)

About the Experimental Study

Given the inadequacy of the current regulatory framework in implementing suitability norms to protect consumers from mis-sale, we conducted a study to evaluate the impact of information disclosures in discouraging consumers from making unsuitable choices, i.e., choices that do not align with their financial circumstances, risk capacity and appetite. Using an experimental design, we examine the purchase decision of our respondents, wherein they are randomly exposed to accurate and inaccurate types of information disclosures about a hypothetical financial product that mirrors closely the features of the AT1 bond. We expect that, given the risks involved, a simple and balanced (that we are calling "accurate") disclosure will reduce the likelihood of the purchase of the bond in comparison to an "inaccurate" disclosure that focuses more prominently on the returns of the product and shrouds the risks involved. **We find that the odds of buying the high-risk financial product are 80-90% lower when exposed to an accurate disclosure as compared to an inaccurate disclosure.**

While the key motivation for conducting this study emerged in the context of mis-selling of AT1 bonds, the applicability of this study extends to a wider array of financial products and services. The implications of this study in terms of the role of a simple, effective, and easy to understand (i.e., accurate) disclosure in ensuring the sale of suitable products and services and enhancing consumer protection are far reaching.

Policy Recommendations

1. **Regulators need to clearly articulate the standard of accuracy in consumer disclosures**
   Our paper provides substantial evidence that accurate disclosures do influence consumer behaviour. While regulators mandate financial institutions to disclose the risks and returns associated with their products, they often do so on general and vague terms which leaves substantial discretion in the hands of the institution. It is neither feasible nor desirable for regulators to give detailed disclosure formats for all the products sold by financial institutions. However, they should outline the minimum principles of accuracy and comprehensibility that such disclosures should adhere to. In the absence of a suitability regime, setting the standards of accuracy and comprehensibility of such disclosures would go a long way in ensuring non-negative outcomes for consumers. Based on the findings of our study and previous literature on this topic, we recommend the following minimum principles of accuracy in a disclosure document -

   - **Features -** There are five areas[5] of information that must be disclosed accurately to the consumer. These are - returns, risk and volatility, costs, early exit and optimal holding period**.**

   - **Language -** Disclosures should be written in a simple and easy to understand language. For technical terms about the product features, the definitions should be explained in an easy-to-understand manner. It would be useful to test existing or new disclosure terms and formats on consumers in the field or in a lab setting before implementing them.

   - **Length -** The length of disclosure should be optimized. Instead of having disclosures that run into several pages, key features about disclosures that are an absolute must for the consumer to know and understand could be included in a summary page of the disclosure document, followed by the longer version of the disclosure (if required).

[5]For a detailed discussion of why these five areas of information disclosure are a must, refer to (Halan and Sane, 2016) here

- **Format** - The format of the disclosure should be paid attention to in terms of the font of the document, parts that need to be highlighted and colour coding the content of the disclosure form. Financial products could be colour coded according to the risk they carry[6]. For example, any product that has the potential of a full capital loss could be coloured as red, a bank deposit could be coloured as green since there is a high degree of safety on the payment of interest and return of principal, and so on.

2. **Institute processes that enable greater accountability and stronger enforcement of disclosure guidelines**
   Along with setting the standards of accuracy of disclosures, regulators need to ensure that there is greater accountability among financial institutions on what they are disclosing. One way to achieve this is to require all sales personnel to sign a declaration form, prior to completing a sale, attesting that the sale has been made only after all the benefits and risks of the product were clearly communicated to and understood by the customer. The form could be counter-signed by the customer to attest this statement. This declaration form should also include a unique sales ID that identifies the sales personnel, irrespective of the organisation that he/she works for. This would ensure that instances of mis-sale can be traced back to the concerned sales professional and thus prevent moral hazard on their part. In addition to this, regulators need to build stronger enforcement mechanisms so as to monitor the industry practices pertaining to information disclosure on a regular basis.

3. **Simplify terms and standardize both formats and product features through consumer testing**
   It is essential to simplify the terms required in the disclosure as well as present the terms in comparison to other similar products. Existing or new disclosure terms and formats should be first tested on consumers in the field or in the lab setting. Using experimental methodologies, policy makers can develop a quick understanding of what formats, language choices, messaging, and delivery mechanisms resonate with consumers. Such practices can improve the design, execution and, delivery of disclosure.

4. **Provider incentives and sales practices may limit the impact of disclosure[7]**
   Disclosure alone may be insufficient to overcome provider incentives and other nonfinancial factors. Disclosure regulation can also benefit from improved understanding of the incentives for firms and sales staff to offer or to not offer certain products, to describe their merits and down sides in an even-handed manner, and to determine how these affects provider-side behavior and, in turn, consumers' financial choices and outcomes. Incentives can be analyzed by consulting with the sales staff, by conducting mystery shopping exercises, and reviewing provider's incentive structure for different product types.

5. **Product Labelling**
   Product labels in the form of colour codes and measurement scales for presenting the risks and returns function as a good visual indicator and can aid the consumer to make better financial decisions. For instance, SEBI has created a 'Riskometer'[8] that captures the risk borne by mutual fund products. The Riskometer acts as pictorial meter and depicts the level of risk in any specific scheme. To make this simple to understand for the customer, SEBI categorizes products based on five levels of risk – low, moderately low, moderate, moderately high, high. For a scheme labelled as moderate risk, investors will understand that their principal will be at moderate risk.

[6]For more details on ways in which disclosures could be improved, see here
[7]Points 3 and 4 has been borrowed from CGAP's focus note on "Applying Behavioral Insights in Consumer Protection Policy", published in 2014.
[8]For more details on SEBI's Riskometer, see here