



Article

The financial institutions incentives when they place financial assets with credit risk to retail investors

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ABSTRACT

This paper analyzes the conflict of interest that exists when a financial institution issues and places a financial asset with credit risk among retail investors. Four regulatory measures are presented and analyzed in order to improve retail investors protection. Theoretically, it is shown that two of these measures, setting a price cap to the issue and an adequate enforcement could implement a first best social optimum.

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1. Introduction

According to the Spanish Survey of Household Finance, in 2005, the 87.6 percent of households held neither stocks nor bonds. Such retail investors behavior is not exclusive of Spain. For example, in the period 1982–1995, according to the U.S. Consumer Expenditure Survey, the percentage of retail investors that held neither stocks nor bonds was more than two-thirds (cited in Paiella, 2007).¹ This behavior is inconsistent with the classic models of optimal portfolio choice (see Merton, 1969 or Samuelson, 1969). Therefore, a large body of literature has been developed to explain this limited participation puzzle of the retail investors.

There are two main theories to explain this puzzle: the first theory states that the retail investor limited participation is due to the high cost of participating in the financial markets (see Vissing-Jorgenson, 2002 or Guiso et al., 2003). Although, participation costs are an important factor for retail investors, the empirical evidence points out that this can only be a partial explanation. Gousskova et al. (2004) showed that “costs are not a major consideration to participate in the stock market”. The other theory argues that the low participation of retail investors is because retail investors are ambiguity averse.

Ambiguity aversion arises in optimal portfolio choice when the investors take into account risk and ambiguity (uncertainty) in their

decision making. Knight (1921) was the first to distinguish between known odds (risk) and ambiguity odds (uncertainty) in individuals decisions. Ambiguity aversion is often attributed to naive investors who do not have sufficient skills to form priors over the occurrence of particular states of the world. So, if naive investors believe ambiguity to be too great, they choose not to participate in the market. Given this framework, Easley and O'Hara (2009) showed that the ambiguity aversion is a sensible explanation of the retail investors low participation in the financial markets.² According to this theory, the retail investors participation could only be higher if the prices of financial assets were sufficiently low to compensate them for their ambiguity-aversion.

Despite the predictions of the ambiguity-aversion theory, it is a fact that financial institutions are sometimes able to sell complex financial assets among retail investors. In particular, they manage to place among their retail clients their own preferred stocks and other funding instruments. This puzzling behavior of the retail investors could be explained by one special characteristic of this type of placements: the issuer and the retail broker belong to the same financial group. Such a characteristic could imply the existence of a conflict of interest between the retail brokers and the investors.

The retail brokers advise investors on the characteristics of any financial products. In theory, the information investors receive

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¹ See Guiso et al. (2003) for participation rates in Europe.

² Other papers, as for example Dow and Werlang (1992) or Epstein and Wang (1994), also proved that ambiguity aversion leads investors with that aversion to avoid participating in a market.

from retail brokers allows to reduce the asymmetric information between issuers and retail investors. Thus, the relationship that is established between a retail broker and their investors could be put on the same level as the relationship between a medical doctor and their patients.

In principle, this relationship would make both parts win. Retail investors could allocate more efficiently their resources in financial assets and brokers would earn the fees for their advices. However, the incentives of the retail brokers and their investors are not always lined up. In the case this paper analyzes, the retail broker faces a trade off. On the one hand, as the issuer belongs to the same financial institution, the retail broker has incentives to place the issue at the highest possible price through advices that tend to minimize the risks of the issue. On the other hand, if retail brokers advise their investors wrongly, they could suffer a reputational cost that will be translated in a reduction of future profits. If there are conditions for the first of the two forces to be stronger, there could be a conflict of interest in the relationship between the retail brokers and their investors.

Despite the fact that the possible conflict of interest analyzed in this paper has not been explicitly studied by the academic literature, a similar conflict, the relationships between stocks analysts and investors, has been studied in several academic papers. In [Malmendier and Shanthikumar \(2007\)](#), the authors found empirical evidence that there exists a conflict of interest in this context. They found that stocks analysts have incentives to bias stocks recommendations upwards, specially if they belong to the same financial institution as the underwriter. However, the behavior of institutional and retail investors differ when they face stock recommendations. Institutional investors adjust downwards their demand for stocks when they are advised to buy. Instead, retail investors follow the recommendation literally.

[Mehran and Stulz \(2007\)](#) argued that a conflict of interest of this type can be avoided if at least one of the following two conditions between the sell and buy side of the relationship is met. The first condition is that the sell side bears a reputational cost if it does not place the best possible product to their investors. The other condition is that investors are sufficiently rational to be able to adjust their investment decision to the possible sell side's conflict of interest. An example of this behavior is described previously in the description of the paper by [Malmendier and Shanthikumar \(2007\)](#).

The possible conflict of interest that could arise when financial products are issued and placed by the same financial institution has not gone unnoticed to regulators. [IOSCO \(2007\)](#) presented a list of regulatory measures that the members of this international standard setter must put in place in case a conflict of interest is detected. In the European Union, the Directive 2004/39/CE of the European Parliament and the Council known as MiFID and the Directive 2006/73/CE of the Commission established the regulation applied within the European Union to remedy these conflicts of interest.

The aim of this paper is to study if a conflict of interest exists when a broker that belongs to the same financial institution as the issuer places a financial asset with high credit risk exclusively among retail investors. As far as the author is concerned, this is the first paper that analyzes this problem taking into account retail investors financial behavior. Financial literature has always approached this conflict of interest from a perspective where investors were only risk averse. Finally, in this paper several regulations are also presented and analyzed against this conflict of interest.

The remainder of the paper is organized as follows. [Section 2](#) describes what ambiguity aversion is and how this type of aversion fits retail investors behavior when they make investment decisions. [Section 3](#) presents the model and describes retail investors, issuers and retail brokers. [Section 4](#) analyzes the outcomes of the model

presented in the previous section. [Section 5](#) compares the private outcome from the model with the social welfare optima. [Section 6](#) proposes four regulatory solutions to approximate as much as possible the private outcome to the first best social welfare optimum. [Section 7](#) provides a numerical example where the four analyzed regulatory measures are compared. Finally, [Section 8](#) lays out the conclusions.

2. Expected utility and ambiguity

In the expected utility theory, decision makers have preferences over, and make decisions between, objective payoff distributions. The application of this theory to financial assets markets assumes that distributions of portfolio payoffs of financial assets are known by the investors. This assumption is usually justified under the rational expectations hypothesis. For some assets and some investors, this could be a reasonable assumption. However, for other investors and assets, it may not be reasonable.

The generalization of the expected utility theory by Savage gave a Bayesian approach to subjective uncertainty about payoff distributions. In this approach, individuals' subjective distribution of payoffs derives from their preferences over stochastic consumption streams. The Savage's approach allows similarly informed investors to disagree on the predicted distribution of payoffs on portfolios. But it does imply that each investor acts as if he or she had some subjective distribution. This could seem reasonable in many cases; in others, however, such as with the example of a new type of asset, it is much less plausible.

In this paper, some of the investors are modeled as Savage expected utility maximizers. It is assumed that these investors are sophisticated and can know the payoff distribution for each asset. The rational expectation assumption for expected utility traders is strong, but standard in the literature. The other investors are aware of the possible payoffs distributions, but they are unable to set a prior over them. These naive investors are what is called in the literature as ambiguity-averse and could be assimilated to retail investors.

There are two reasons for considering some investors ambiguity-averse. In the case of many investors, the expected utility theory yields optimal portfolios that are different from the actual ones. In the case of retail investors, the expected utility theory predicts diversified portfolios, while this kind of investors hold portfolios that prioritize some kinds of assets.³ The other reason is that there is evidence that some individuals and by extension, some investors, do not act as if they had a rational prior. One of the most famous examples of this behavior is the Ellsberg paradox ([Ellsberg, 1961](#)). In the simple version of the Ellsberg experiment, an individual bets on the draw of a ball from one of two urns. In one of the urns, there are fifty black balls and fifty red balls. In the other urn, there are one hundred balls, which are an unknown mix of black and red. Two gambles are proposed and the individual has to choose one of them. In the first gamble, if a red ball is drawn from urn one, the individual wins one euro and zero euros if a black ball is drawn. In the second gamble, if a red ball is drawn from urn two, the individual wins one euro and zero euros if a black ball is drawn. If the individual chooses the first of the gambles, it could be interpreted as if he had set a prior on urn two where he has predicted that there is less than 50 percent of red balls.

Next, the same individuals are offered to choose between two new gambles over the same two urns. In the first gamble, if a black ball is drawn from urn one, the individual wins one euro and zero euros if a red ball is drawn. In the second gamble, if a black ball is

³ See [Isperto and Villanueva \(2010\)](#).

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