

Information provision by financial intermediaries under specialized and one-stop banking

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EXECUTIVE SUMMARY

It is quite common that uninformed customers that purchase from a financial intermediary a product on the advice they receive. Still, this may lead to a conflict of interests. Examples of this are the misselling of pension funds in the UK, the information provided by Merrill-Lynch to its investors, or the recent unilateral renegotiation of life insurance contracts in the UK.

In a world of verifiable information, customers are able to sue the financial intermediaries for the incorrect advice they have received, and therefore giving interested misleading advice would never arise.

As this is seldom the case, it is interesting to emphasize the opposite case, of unverifiable information. In this case, the customer may be protected when the financial intermediary's reputation is at stake. Yet, in general, there is a trade-off between profit and reputation and, consequently, the issue of the financial intermediary strategic information provision has to be addressed explicitly as we do in our model.

This simple set-up allows us to explore how financial intermediaries are expected to behave in different market structures. Namely, we will study how the information provision of information is affected by the following dimensions of the financial markets:

- The structure of the banking industry : specialized banking vs. One-stop banking
- The market power of each financial intermediary
- The existence or not of switching costs.

As we will see, these three aspects are intertwined and will jointly determine the quality of the information provided to customers.

To provide a simple framework, the paper considers two types of financial products and two corresponding types of customers, both denoted by A and B. In a specialized banking framework, each bank produces either A or B; in a one-stop banking framework, a bank produces both A and B. The production cost of those financial products is normalized to zero, so that each price is equal to the spread over the marginal cost.

THE MARKET STRUCTURE

One stop banking.

To begin with consider the case of one-stop or integrated banking. The bank has no conflict of interest in giving reliable information to the customers once its margins on each product are close enough, so that the bank prefers to reveal its true type to each customer rather than incurring a reputation cost. The customer will then purchase the recommended financial product from the bank that has provided the information. But this implies that the customer has to be ex post captive, or in other terms that the cost for a customer of switching to a competing bank after being revealed its type is sufficiently high. The first implication of this is that information provision requires the existence of sufficiently high switching costs; the second implication is that the bank has ex post a monopoly of information on the customer and will, therefore, extract the whole surplus. The existence of competition by banks that do not provide information will not change this result. Even if the other banks sell at the competitive price, the prospect of being given the right information on their type will induce the customers to go to the bank providing information, even if the prices are higher. In equilibrium, though, the gain to customer will vanish (for high switching costs)

Specialized banking

Consider now the decision of a specialized bank that sells product A. Its decision to inform a customer that her type is B and therefore should not purchase product A does not seem credible. But in fact, as our model reveals, it may be in the interest of A to provide some information. This is clear whenever, absent information, customers prefer to choose product B. Indeed, in this case, competition will drive down the price of A to zero and, in spite of

this, A will end up with no customers. As a consequence, it is optimal for A to provide information so as to attract customers. Those that are revealed to be B will go to the B bank and purchase product B, and those that are revealed to be of type A may choose to purchase A or to play a mixed strategy in case the information provided by A is not fully reliable. Our model shows that in equilibrium, the mixed strategy played by the customers will make the bank indifferent between providing reliable information or low quality information. It should be emphasized that the necessary condition for this to occur is that informed customers are still able to choose the product after receiving information, that is, there are no switching costs. This is precisely the opposite assumption that was required in the one-stop banking case. But in addition, once we consider the bank's incentives to invest in providing information, (choosing highly skilled employees and training them, providing adequate software), it becomes clear the second necessary condition for a bank to invest in information is that it is profitable. As a consequence, in a perfectly competitive market where the price of product A will be close to zero there will be no information provision.

To summarize: information provision will occur under one stop banking provided that there are high switching costs; it will occur under specialized banking provided that there are no switching costs and that the bank providing information has some market power, as it would occur after developing a financial innovation.

THE EFFECTS OF INTERNET

The existence of internet may affect the above equilibrium in three different ways.

First, internet may provide reliable information on the customers types. This occurs, for instance, in the market for stocks, where customers have access to all available information on stocks and need not trade with the information provider.

Second, internet may have an impact on competition. This has occurred in the deposit and mortgage market, where internet banks attract customers through lower prices.

Third, internet may have an impact on switching costs, by providing information on the alternative conditions offered by competitors.

INFORMATION PROVISION EFFECT

Assume, first, that internet allows the agents to know their types. In our context, this implies that the banks are left with a captive demand. Absent this information there was some degree of competition between the two markets. Once the customer know their types, the substitutability between the two financial products strongly decreases. If the markets are competitive, this leads to a Pareto superior allocation without affecting the banks profits; if the markets are non-competitive this leads to higher profits for the banks and lower profits for customers.

Thus, somewhat surprisingly, information production, by decreasing the perceived substitutability of the two financial products allows the banks to increase their prices and only if the market is sufficiently competitive, will all the customers benefit from the production of information.

INCREASED COMPETITION EFFECT

When the effect of internet is to increase competition, even in the presence of zero switching costs, specialized banks will stop providing information. Still, when switching costs are high, there will be stronger incentives to create financial conglomerates that will provide information while remaining sheltered from competition because of their ex post monopoly position. Therefore, the impact of internet is here to promote one-stop banking if switching costs are high and to suppress the incentives for specialized banks to provide information in the zero switching cost case.

DECREASED SWITCHING COSTS

Finally, as internet decreases the cost for customers to shop for alternative products, the costs to obtain timely information and the efficiency in agent monitoring, it may decrease switching costs.. Within our framework, this implies that the incentives to create financial conglomerates will decrease, while specialized banks incentives to provide information will remain unchanged.

