TESI FINALE


• Legal and economic approach to tying and other potentially unfair and anticompetitive commercial practices: focus on financial services.

• Shaping Reforms and Business Models for OTC Derivatives Markets: Quo Vadis?

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Abstract

In the aftermath of the subprime crisis, regulators are trying to design reforms able to fix market failures and reduce distortive incentives in this huge market. Subprime mortgages represent an important tool for wealth accumulation, but origination and distribution processes are affected by strong information asymmetries and cognitive biases (rational and irrational). We will show as the failure of the subprime mortgages market was triggered by a mixture of irrational and opportunistic behaviours, as well as a lack of regulation, supervision and efficient disclosure.

This paper, therefore, is structured in four parts. The first part briefly describes the financial architecture of the subprime market and the characteristics of the financial product, which shows the features of an experience (or credence) good. The second and the third part will deal with the major actors in the origination and securitisation process, highlighting the main points of failure that triggered the subprime crisis. Finally, the fourth part will give policy responses, promoting regulatory and supervisory actions vis-à-vis market initiatives and the legal recognition of a fiduciary relationship. These responses are designed to address moral hazard and adverse selection issues, acting on four areas: mandatory disclosure and simplification; suitability test and the "optional warranty"; assignee liability or retention mechanisms; reputational mechanisms and stronger supervision. A better understanding of market failures and lessons drawn by the recent financial crisis should push knowledge into the regulatory process that aims at reforming the subprime market and other areas of financial markets so far not wisely regulated.
SUMMARY

1. INTRODUCTION .................................................................................................................. 5

2. THE SUBPRIME MORGAGES MARKET .............................................................................. 6
   2.1 PRODUCT CHARACTERISTICS ..................................................................................... 13
   2.2 THE FINANCIAL STRUCTURE ....................................................................................... 18
   2.3 HOMEOWNERSHIP VALUE .......................................................................................... 22
   2.4 PREDAATORY LENDING ............................................................................................... 23

3. MAIN DETERMINANTS OF THE BORROWER’S CHOICE TO GET IN A SUBPRIME MORTGAGE .......................................................................................................................... 24
   3.1 COGNITIVE BIASES: AN OVERALL ANALYSIS ................................................................. 26
   3.2 SUBPRIME MORTGAGES INCENTIVE STRUCTURE .......................................................... 30
      3.2.1 RIDING THE BUBBLE: WHEN THE BORROWER “APPEARS” RATIONAL .............. 32
      3.2.2 PREPAYMENT PENALTY CLAUSE: “GHOSTS BUSTING” ................................... 38

4. THE INCENTIVE STRUCTURE OF INTERMEDIARIES: MORAL HAZARD AND ADVERSE SELECTION ......................................................................................................................... 40
   4.1 BROKERS ......................................................................................................................... 41
   4.2 ORIGINATOR LENDERS .................................................................................................. 44

5. SOME RESPONSES: HOW DOES THE POLICY-MAKER SHAPE THE SUBPRIME MARKET? .............................................................................................................................................. 47
   5.1 REGULATORY INTERVENTION: LOOKING “OVER” THE CRISIS ................................... 48
      5.1.1 MANDATORY DISCLOSURE ....................................................................................... 49
      5.1.2 SUITABILITY REQUIREMENTS: AN “ELEGANT” WAY OUT TO THE LENDERS’ OPPORTUNISM ......................................................................................................................... 51
      5.1.3 OTHER RESPONSES .................................................................................................. 55
         5.1.3.1 Interest rate ceilings: a “pro-usury” law ............................................................... 57
   5.2 REPUTATIONAL MECHANISMS AND SUPERVISION ..................................................... 59

6. CONCLUSIONS ...................................................................................................................... 60
1. Introduction

The recent global financial turmoil - triggered by the uncertainty around the stability of big financial institutions across the world – has shed new lights on US credit markets: in particular, on the market for subprime residential mortgages. The market for subprime mortgages mostly grew in a deregulated environment from the early 90s. It reached the peak in 2006, with a share of around 20% of the total mortgages originations in the US. The aim of this work is to analyse the subprime mortgages origination process (and indirectly its securitisation mechanisms) with the precious tools offered by the Law and Economics (L&E) and the principles of securities regulation. The new insights from the L&E doctrine on the implications of human behaviours and new ways of “debiasing through law”1 permit to analyse and propose remedies to the failures in the origination and securitisation process, in order to address weaknesses affecting their main actors. The theoretical aspects will take stock of the empirical evidence showed by the crisis, as part of our adopted micro-approach, in the following sections.

This essay describes, on one hand, the complexity of the market, which is enhanced by borrowers’ biases and low financial education vis-à-vis the specific characteristics of subprime mortgages as experience (or credence) goods (rather than search goods)2. In effect, financial and behavioural aspects surrounding this transaction increase borrowers’ misunderstanding of the real risk they are going to bear. On the other hand, a distorted structure of incentives for brokers, originator lenders and loans’ packagers lead towards opportunistic behaviours, as “steering” and “churning”3, for instance. Their opportunism consists in exploiting informational gaps and their contractually dominant

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2 Products and services can be classified in three categories: search goods; experience goods; and credence goods. A search good consists in a product or service for which is possible to assess the quality before the purchase. Search elements include those attributes of the relationship that are easily detected and understood by customers, even when they are deciding whether to switch to a competing provider. An experience good, instead, is a product or service for which the buyer can evaluate the quality only after the purchase and its use. Finally, a credence good is a product or service whose value and quality cannot be assessed even after its use, as features cannot be easily compared with other products or services. It is the “grey area” where customers do not have any knowledge of what is in the contract, and what it means in terms of its relationship with the provider. See Darby e Karni, Free Competition and the Optimal Amount of Fraud, 16 Journal of L. and E., 69 (1973); and Nelson, Information and Consumer Behaviour, 78 Journal of Pol. Econ., (1970).

3 “Steering” is a practice the placing of borrowers into unnecessarily expensive loans; see Ernst, Boci an and Li, 2008. The risk coming from this deceiving practice has been also recognised by the US proposal to introduce new rules for mortgages, now in the Senate; please, see House of Representatives, H.R. 1728, Mortgage Reform and Anti-Predatory Lending Act, May 2009, §103, Title I. “Churning” is basically a legal term to define a practice imported from securities regulation; SEC defined it as an ”excessive buying and selling of securities in your account by your broker, for the purpose of generating commissions and without regard to your investment objectives”, http://www.sec.gov/answers/churning.htm. It was firstly judicially defined in Hecht v. Harris Upham & Co., 430 F.2 days 1202 (2nd Cir. 1970).
power over the typical subprime borrower. We will mainly focus on the origination process and indirectly on the securitisation mechanisms for transferring risk to the market, which played a pivotal role in the widespread diffusion of those troubled assets that have shaken the global financial system.

We will show as failures in the subprime mortgages market were triggered by a mixture of irrational and opportunistic behaviours, as well as a lack of regulation, supervision and efficient disclosure. Ashcraft and Schuermann (2008) identified a list of frictions behind these failures, which we have redefined as below:

1. Adverse selection and predatory lending practices between borrower and lender;
2. Moral Hazard between appraiser and borrower (and indirectly lender);
3. Moral Hazard between originator and arranger of the securitisation;
4. Adverse selection between the arranger and investors;
5. Moral hazard between servicer and investors;
6. Moral hazard between asset manager and investors;
7. Conflict of interests and moral hazard of credit rating agencies over final investors.

The paper, therefore, is structured in four parts. The first part is going to briefly describe the financial architecture of the subprime market, the characteristics of the product and its role in the current financial markets. This part will reveal five of the issues above. The second and the third part will deal with the origination process and its two actors, borrower and intermediaries (brokers and lenders), revealing the other two issues that caused the subprime crisis. Finally, the fourth part will give some responses based on regulation (and public-private enforcement), supervision and the use of reputational mechanisms to reduce the risks related to high-risk markets. The identification of subprime mortgages as experienced (or credence) goods allows us to use tools of the securities regulation to address relevant market failures.

2. The Subprime Mortgages Market

The market for residential mortgages is an essential tool for wealth accumulation, especially for low and moderate-income borrowers (e.g. subprime or “not conforming” mortgages). However, this financial transaction carries many potential complications and risks for both parties. In effect, typical subprime borrowers are borrowers with:

“weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced
repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that many encompass borrowers with incomplete credit histories.”

In legal terms, there are two definitions of “high-priced” loans (e.g. subprime mortgages).

On one hand, there is a recent definition of “higher-priced” loans, as defined in the final rules of the new Regulation Z. A “higher priced” loan is “as consumer credit transaction secured by the consumer’s principal dwelling for which the APR on the loan exceeds the yield on comparable Treasury securities by at least three percentage points for first lien loans, or five percentage points for subordinate-liens loans”.

On the other, the Home Ownership and Equity Protection Act (HOEPA) defines a second restricted category with specific requirements (limited prepayment penalties and balloon payments, no negative amortization and no lending practices based exclusively on the value of the collateral) and pre-closing disclosure on extremely high-costs refinancings and home equity loans. The HOEPA high-costs loans are “closed-end, non-purchase money mortgages secured by a consumer’s principal dwelling (other than a reverse mortgage) where either: (a) the APR at consummation will exceed the yield on Treasury securities of comparable maturity by more than 8 percentage points for first-lien loans, or 10 percentage points for subordinate-lien loans; or (b) the total points and fees payable by the consumer at or before closing exceed the greater of 8 percent of the total loan amount, or $547 for 2007”.

The growth of the US market for subprime mortgages began in the 90s after the wave of deregulation of the decade before and the elimination of the anti-usury laws (McCoy and Renuart 2008). In 2007, 7.2 million families held subprime mortgages for an outstanding value over $1.3 trillion, which is 3 times more of the size of this market in

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5 The APR is the annual percentage rate of the received loan. It helps to compare the different offers.


7 Id., p. 12.

8 The common law specifically recognized the possibility for national banks to export the interest rates from their home States to other States, moving a step forward in the process of usury caps elimination; Marquette National Bank v. First of Omaha Service Corp., 439 U.S. 299 (1978) interpreting the provision at 12 U.S.C. § 85.
In particular, a mixture of five important aspects led to this fast market growth:

- The volume-based incentives in the securitisation process (firstly appeared in the 1930s\(^9\)) and the credit score model for risk assessment;

- The privatisation of Fannie Mae and Freddie Mac\(^10\);

- The Community Reinvestment Act (CRA)\(^12\);

- The Federal Housing Program promoted by the US Government to increase the homeownership rate\(^13\);

- The long-run positive trend of house appreciation linked to low interest rates and to the large availability of liquidity in financial markets; as always, a rapid and uncontrolled market growth pushes people to underestimate and overlook relevant risks.

First of all, the huge amount of resources freed through the securitisation of loans (Peterson 2007) counted in 2007 to around 60% of the overall resources in the mortgages market (Barth et al. 2008). The crucial role played by savings and thus stable commercial banks was replaced by less stable and capitalised investment banks (often divisions of commercial banks) and other financial institutions. In effect, the huge business of securitisation gave the possibility to transfer risk and, at the same time, to expand the credit market thanks to the freed resources, which allowed more lending to low-income borrowers through new pricing models primarily focused on risk (Feldstein

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\(^10\) Only in the 1970s it became a standard tool to fund mortgages thanks to the Government National Mortgage Association (GNMA or Ginnie Mae), the Federal National Mortgage Association (FNMA or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac); see, in general, Kendall and Fishman, 2000.

\(^11\) Fannie Mae and Freddie Mac were shareholders-owned since 1968 (with President Johnson). Their private ownership contributed to the uncontrolled growth of this market. On 8th September 2008, the US Government decided to take over these GSEs (Government-Sponsored Enterprises), which became GOCs (Government-Owned Corporations).

\(^12\) This regulation was supported by other three important regulatory interventions: the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980, making subprime legal through charging higher fees and rates; the Alternative Mortgage Transaction Parity Act (AMTPA) of 1982, allowing the use of variable interest rates (ARMs) and balloon payments (now repealed in the new reform); the Tax Reform Act (TRA) of 1986, allowing deductions of interests for mortgages on a primary house; see Zywicki and Adamson 2008, Gramlich 2007b, Peterson 2007 and McCoy & Renuart 2008.

\(^13\) The Federal Housing Administration (FHA) and the Department of Housing and Urban Development (HUD) have explicitly confirmed the federal objective of “an ownership society” (Jaffee and Quigley 2007); also President George W. Bush has often reminded the fundamental role of expanding homeownership in particular for low-income borrowers ([www.whitehouse.gov/infocus/homeownership](http://www.whitehouse.gov/infocus/homeownership)) and protecting American Families in this crisis with legal interventions as the Mortgage Forgiveness Debt Relief Act of 2007.
2007, Block-Lieb and Janger 2006). These market developments, as described in the next paragraphs, created incentives based on volumes, which led the subprime mortgage industry to be a relevant part of the US economic system. At the centre of this credit market there is an automated and centralised system of credit scoring, so called FICO\textsuperscript{14}. This automatic system, assigning a number to the borrowers’ riskiness as defined by a proprietary model, helps to reduce transaction costs. However, this score does not catch the relativity of the risk so, as shown in figure 5, lenders may also make a prime mortgage to borrowers with a low FICO score and vice versa. Furthermore, due to reputational mechanisms\textsuperscript{15} and the strategical passage towards a new way of funding (securitisation), the critical role of assessment and management of subprime risks has not been run anymore by big financial institutions, but mainly by small State-chartered companies or affiliates of big banks with marginal supervision and low capital requirements, as main subprime loans’ originators. In effect, they have counted for almost 80\% of all US originators, if we consider affiliates of banks and other subsidiaries (Gramlich 2007b). These entities are mostly non-depository financial institutions with less supervisory and regulatory restrictions. Banks are usually less involved for reputational concerns (20\% of the overall market), even though the system has been fuelled by banks’ purchases of RMBSs and CDOs\textsuperscript{16}. We will describe these players more into details in Section 5.

Secondly, the privatization of Freddy Mac and Fannie Mae gave further bad incentives to the securitisation process. A conflict between two interests occurred: the long-run financial stability of the whole securitization process and the short-termism of preserving profitability, so the shareholders’ value. In effect, the pressure of the latter dominated when the growth of this market became uncontrolled. The failure of these two GSEs pushed the US Government to completely renationalize those GSEs, burdened by hundreds billions of “troubled assets”\textsuperscript{17}.

Thirdly, the first regulatory act that formally recognized the role played by credit market to improve wealth accumulation for low and moderate-income borrowers was the Community Reinvestment Act of the 1977. This regulation was intended by the Congress, on one hand, as an offensive against racial and ethnic discrimination in the accumulation of wealth and, on the other, as a way to increase the homeownership rate. It partially succeeded to promote prime and subprime lending to people with different

\textsuperscript{14} From the name of the Fair Isaac Corporation which releases these credit scores based on a proprietary model. This is the main credit score model used in the US credit market.

\textsuperscript{15} In effect, big financial institutions have not been involved in the market for subprime lending as a direct involvement could undermine their reputation of financially stable institutions.

\textsuperscript{16} Residential Mortgages Backed Securities and Collateralized Debt Obligations.

racial and ethnic origins, even though the discrimination is still a relevant issue in the wealth accumulation programs (Bar-Gill and Warren 2008).

Fourthly, the subprime mortgages market was fostered by a Federal Housing Program to increase the homeownership rate and other legislative initiatives, like tax deductions of interests with the Federal Tax Reform Act (TRA) in 1986.

The figure 1 shows us a slight but steady increase of the homeownership rate in the last 15 years for all these initiatives. The rate reached its peak in 2004, to gradually descend in 2008 around 68%. The turmoil in the real estate market and the following house depreciation have been widely considered as result of the excess of liquidity in the system. It may also represent the gradual achievement of a peak that could be considered as a “natural rate” of homeownership for the economic system.

**Figure 1**

![US Homeownership rate](chart)

Source: US Census Bureau

In 2006, the subprime market represented around 28% of the overall number of originations, with a value of circa $1 trillion. More than 80% of these loans were packaged through mechanisms of securitisation (Fig. 2; Barth et al. 2007b, Gramlich 2007b).
Last but not the least, the constant house appreciation created an attractive background (especially in the last 10 years) to get in risky financial transactions in order to become homeowner (see figure 3). An important role in the story is played by house appraisers, who are entrusted with the valuation of the property. This is a highly subjective process and, even if they should follow a set of rules and guidelines to determine a property’s fair market value, they evaluate the property more or less directly influenced by lenders or brokers or borrowers who hired them. In addition, also the shortage of houses to rent strongly contributed to inflate home prices in a period of a background growth. The higher the rents, the more attractive the home purchase is.

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In the period 2000-2007, interest rates for the most representative conforming residential mortgage (30 years fixed rate) have been at the lowest level in the last 36 years promoting an excessive use of credit, especially for first-time home buyers and refinancing loans. Also fees – as percentage points - have been low for long time (see figure 3). It is debateable whether this period of low interest rates and house appreciation triggered the bubble in the real estate market and the instability of the subprime credit between 2003 and 2006 (Taylor 2007). However, it is unquestionably true that a period of low interest rates may reduce alternatives of investment, in particular for people with low and moderate-income, who need new tools for wealth accumulation. The home purchase has been the most stable and safe investment for this category of borrowers. Then, as described in the following paragraph, this artificial market conditions led borrowers to perceive the costs of indebtedness as very low, even with explicit teaser rates (in adjustable-rate mortgages, ARMs) and other “deceivable” conditions (e.g. unfair penalties or prepayment clauses).
2.1 Product Characteristics

The subprime mortgage is a heterogeneous, complex and customized product characterized by several aspects related to the pre-contractual and contractual phases. The following items have been identified as peculiar aspects of a subprime mortgage (Cutts and Van Order 2005; Block-Lieb and Janger 2006):

− Much higher interest rates vis-à-vis prime rates, and enhanced adverse selection problem and moral hazard issues;
− Prepayment penalties;
− Low loan-to-value ratios (usually) and high rejection rates;
− Non-linear profits;
− FICO scores typically below 660;
− Bad borrowers credit history (30-days delinquencies, bankruptcy, foreclosure, judgments, etc);
− Debt service-to-income ratio of 50% or greater;
− Several kinds of fees.

All these characteristics make the market for subprime lending risky but profitable in the short run, in particular if risks are transferred to the market through securitisation mechanisms.

Adverse selection and moral hazard: credit rationing

As Stiglitz and Weiss showed in their seminal article (Stiglitz and Weiss 1981), the credit is rationed in the long run because the equilibrium is affected by asymmetric information. The adverse selection is an informational problem structurally related to the difficulty by one of the two parties to process some kind of information, such as the quality of the products. In Akerlof (1970), the classical example to explain this informational problem is the market for lemon cars. The adverse selection, in effect, arises when products of different quality (e.g. lemon and good cars; junk and good bonds and so on) are sold at a single price because of asymmetric information (inability of the buyer or lender to understand the real quality/risk of the cars/financial product or borrower), so that too much of the low-quality product and too little of the high-quality product are sold. In the market for lemon and good cars, for instance, the equilibrium will result in a market price (due to the inability of the buyer to understand ex ante the quality of the product) a bit higher than lemon cars’ real value and consistently lower than good cars’ real value. Hence, the market equilibrium, in the mid-term, will determine that only lemon cars are sold in the market. This important issue can basically bring a market to the end, justifying mechanisms of signalling as third-party informational role (rating agencies, etc), regulatory interventions or just pre-sale services. See Pindyck and Rubinfeld (2005), id., p. 616; Reinier H. Kraakman, “Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy”, Journal of Law, Economics and Organization, Vol. 2, No. 1, Spring
more informed about product quality helps to exclude virtuous practices from the market (Akerlof 1970). The scarce ability of the lender to assess borrowers’ risk brings to a sub-optimal outcome (pooling effect) pushing good borrowers out of the market and justifying the credit rationing. In effect, there is a general willingness of borrowers to disclose good information and to retain bad ones (borrower's opportunism), in order to obtain in the end better terms. This issue structurally compromises the overall understanding of the borrower's risk profile. In addition, the limited possibility to foresee exogenous factors of risk and cognitive biases - which we will analyse in the next section - further increases the difficulty to identify good borrowers. Therefore, the final outcome is the general increase of interest rates and enhanced pooling effects.

The interest rate, hence, tends towards a higher level (especially in the subprime market), attracting riskier borrowers (see figure 4) - since their inelastic demand for credit - and putting aside good borrowers that may not show their “real” risk profile, as the lender - due to the moral hazard of the risky borrower – cannot have the certainty that borrowers is not retaining sensible information (adverse selection effect). Therefore, the higher the rate is, the higher is the risk of pooling effects and the final outcome will include mainly risky borrowers. Hence, especially in the subprime market but in the credit market in general, different screening devices are needed. For instance, tightened underwriting standards (and better risk assessment) and collateral requirements may in the end help to reduce credit rationing (Bester 1985). Moreover, competitive forces are not enough to lead supply equals demand of funds, so credit is often rationed as bad borrowers tend to prevail over the good ones.

Figure 4

![Expected bank's returns](source: Stiglitz and Weiss (1981))

1986.
In effect, as shown in the figure above, fixing the interest rate higher than a certain value will reduce the expected returns of the bank, as high-quality borrowers will perceive a too high cost of indebtedness, so refusing to get credit from the bank. Instead, low-quality borrowers, who often are also low-income (e.g. subprime borrowers), will feel less the cost of indebtedness as they probably need to get credit as they have less alternatives. For instance, they may have asked for credit in order to buy a first home in a market where rents in the long run are not sustainable for their current income. Their demand, hence, will be more inelastic than high-quality borrowers. In conclusion, it is structurally more difficult to assess the risk profile of low-quality borrowers, as they also have more incentives to retain sensible information.

**Other relevant aspects**

About underwriting standards, a credit scoring system is widely adopted to refine lenders’ prediction of default risk\(^{21}\) (through risk-based pricing tools) in the subprime market. The reference point is 620, under which a borrower should be classified as subprime, even though the relativity of the risk spreads subprime borrowers on a range up to over 800 (see figure 5). Hence, this number generally represents an artificial border between prime and subprime mortgages, which is adapted in relation to the real risks and other conditions (as collateral and legal jurisdictions) assessed by the originator. The use of credit scores, which tend to uniform scores around a middle value (as in general this automated system is not able to catch the relativity of the risk), and borrowers’ opportunistic behaviour (who withhold information to the originator, especially by risky borrowers) enhance, on one hand, adverse selection problems and, on the other, the difficulty to assess real risks of low-income borrowers, in particular. Therefore, an automated credit score system determines more availability of consumer credit and a fictitious reduction of information barriers, principal reason of credit rationing (Barron and Staten 2003), as well as transaction costs. The most used system of credit scoring relies on borrower’s payment behaviour, as described by her credit history. As we will show in the next section, this automated system is not sufficient to predict - with a marginal range of error - borrowers’ riskiness. The presence of cognitive biases and unforeseeable exogenous factors – like job loss, illnesses, etc – may require a more detailed analysis before originating a new loan to a non qualified borrower.

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Another indirect way of screening risk profiles is the request of collateral requirements. These requirements imply that mortgage originators pursue a deep analysis and investigation of the risks related to the transaction, in order to request enough collateral protection. However, very strict collateral requirements may decrease bank’s returns by reducing the degree of risk aversion of the borrowers’ pool, so inducing individual investors to undertake riskier projects in a multi-period model (Stiglitz and Weiss 1981). Therefore, it could be not profitable to indiscriminately increase interest rates and collateral value requirements in credit markets. In the market for subprime mortgages - which basically relies on high interest rates, low collateral requirements (as typical borrowers have no or few assets) and cognitive biases - lenders are expected to face powerful issues, as adverse selection problem and moral hazard. The interest rate is a weak screening device in a credit market for high-risk borrowers.

Concerning with the prepayment penalty, if used in the right way, there are two reasons to consider it an efficient tool. Firstly, with the subscription, it improves lenders’ ability to extract private information from borrower on its riskiness. Secondly, it is a way to recover the high origination costs linked to lender’s activities in the subprime market. However, there is a high probability that this clause might be used in a wrong way by lenders (see section 3.2.2).

Another remarkable characteristic of subprime financial products is the non-linear response of profits to interest rates (Borio 2007). This kind of lending is more responsive to changes of interest rates (payment shock) or collateral value. The boom and consecutive burst of the subprime market, due to the changes in market conditions, is an unquestionable example of this non-linear effect. So the tendency is towards a rapid growth when there is a house appreciation trend and towards a rapid decrease when this trend is going down, due to the financial accelerator (Bernanke et al., 1998).

The long list of fees is another aspect of subprime mortgages, especially with the latest developments. The high costs of servicing, origination and eventually foreclosure and/or bankruptcy, lead lenders in many cases to request the payment of several fees, not included in the regular loan payments. In effect, the high delinquency rates in the
first months increase the probability that these initial costs will not be recovered if included in the periodic payments.

In addition, subprime mortgages, for the specific characteristics of low-income borrowers and intermediaries, are more comparable to experience goods than search goods (in particular for “uninformed” home-buyer demand segment), even though it may appear the opposite. Search costs, due the market segmentation\textsuperscript{22}, and financial sophistication for subprime borrowers are very high and only 31\% of subprime borrowers have searched a lot for the best interest rate available from different originators (Lax et al. 2004). Moreover, a low-income borrower usually understands only after a certain period of time whether the product and related services (own risk-evaluation) were suitable for her risk profile (not considering exogenous shocks “not reasonably” foreseeable\textsuperscript{23}). The low demand elasticity to interest rates, typical characteristic of the subprime borrower, testifies as borrowers miss some information on quality or price. This peculiarity gives some more information on the nature of experience good of this product. Being a “not frequent” purchase, then, does not allow people “to learn” from the repeated use (Schwartz and Wilde 1978). In effect, if a sufficient number of subprime consumers become informed, positive externalities of their comparing activity would avoid moral hazard and adverse selection since the increase competition (and screening) and so the availability of credit (Villas-Boas and Schmidt-Mohr 1999; Hynes and Posner 2001). Conversely, the number of subprime borrowers who “shop around” because really informed about price and suitability of mortgages is very low, due to low financial literacy and cognitive biases of a typical subprime borrower. Hence, few marginal borrowers cannot protect with their purchases the uniformed ones. In addition, the limited role of substitutes (credit card, personal loans, etc) does not help to improve competition in this market. There is thus a need of specific conduct of business rules to address potential conflict of interests (see section 5).

It is empirically showed that the subprime lending is ten times more delinquent than prime lending\textsuperscript{24} and it is more concentrated in cities with higher economic risk, with a weak labour market and declining house prices (Pennington-Cross 2002). Even though a regular rate of payment shocks and default is a normal development in this market, there is a need of a specific regulatory and supervisory intervention to stabilize this rate.

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\textsuperscript{22} In the subprime market, licenced brokers play a crucial role. Therefore, the limited channels of distribution have also created incentives to segment the market in specific areas (Ernst et al., 2008).

\textsuperscript{23} This mitigating default rule was firstly enacted by the English Court of Exchequer (presiding Baron Alderson) in Hadley v. Baxendale case of 1854; 9 Ex. 341, 156 Eng. Rep. 145, 1854; the regulatory and supervisory interventions of the last part ought to help us to understand what is “fairly and reasonably foreseeable” (what was supposed to be fair and reasonable at the contemplation of the parties when the contract was signed).

to a sustainable one.

Finally, the loan-to-value ratios, which should be at low value as high-risk transaction, dramatically increased between 2001 and 2006, as the average size of subprime credit soared from $151,000 to $259,000 (Bar-Gill 2008).

2.2 The financial structure

The financial architecture behind the origination subprime mortgages is mainly centred on the securitization process (see figure 6). Three steps can be identified:

- Origination;
- Securitization; and
- Placement.

The origination consists in the creation of new mortgages, which represents a future flow of payments. Originators are supported by appraisers, who estimate the value of the property, brokers, who search for new borrowers and design the most suitable transaction for them, and wholesale lenders, which provide the originators with the liquidity actually needed to increase the volume of originations.

The securitisation is the stage in which loans are packaged through a special purpose vehicle (SPV) created by the arranger, and through government agencies (Fannie Mae and Freddie Mac. As shown by the last crisis, arrangers may also underwrite some of the issued products.

The last stage is the placement of these products directly to final investors (mainly professional investors) or indirectly through further packaging in other Collateralised Debt Obligations (CDOs squared and cubed), in order to spread risk even more, on one hand, and increase ratings through adding them in higher quality portfolio of assets, on the other. Finally, the servicer helps the SPV to collect and make payments and borrowers to manage their payments and their financial exposures. Its incentive is to keep the loan on its books for long time, even though it is defaulting, in order to generate more fees.
The aim of this work is to deeply analyze the origination part of the process, because a central role in this crisis has been played by the way in which mortgages are originated and how borrowers’ behaviour affects this process. Then, distorted incentives coming from the securitisation process led involved players to push on transaction volumes, but without tools and specific conditions of the market the increase in the originations would have been more difficult.

Then, the home value as collateral and its role in the wealth accumulation process are core aspects for both origination and securitisation processes. The moderate and low-income consumers borrow money from lenders (usually small State-chartered companies), mainly through brokers who have most of the time a personal relationship with the borrower. Lender’s risk-based evaluation basically relies on credit scores and on the value of the collateral (the house value; often the only collateral requirement over the credit score). Appraisers, who are on the lenders or/and borrowers’ payroll,
determine this value. Therefore, with incomes tied to the origination of loans but not to the performance, borrowers and originators appear to have the same incentives to obtain appraisals supporting the approval decision rather than providing unbiased estimates of property value\textsuperscript{25} that reduces the probability to fill the standards framework\textsuperscript{26}. Moreover, to be able to provide the requested amount, small lenders (but not only them) frequently borrow money from big warehouse.

Furthermore, the second stage of the game is the securitisation process, which allows transferring risk to the market and, at the same time, freeing resources to invest in the same or other markets. Originators sell loans to big investors/lenders, which will package the assets in Special Purpose Vehicle (SPV) through arrangers with the subsequent issue of securities (RMBS and CDOs) rated by credit rating agencies (CRAs). This vehicle issues mortgage based securities (MBS) that will be placed to the final investors in tranches with different seniority, in order to match the diverse risk appetite of final investors. Final investors are mainly professional players, as mutual and pension funds, other investment banks (or the same arranger that underwrites some of the securitised products) and hedge funds.

The financial incentives of this mechanism, by contrast, enables lenders (originator) to gain advantages through withholding information on loans to the buyers and originating more loans without excessively caring to underwriting standards. This outcome undermines the whole system and produces potential sources of systemic risks (see section 4). Therefore, these distorted incentives may require additional efforts to assess the real quality of the assets pool and to reduce incentives on transaction volumes. Concerning with benefits, the securitisation (and related secondary market for mortgages) grants more resources to the system, reduces the cost of procuring additional funds, increases the profits on sale for originators reducing credit rationing, improves market liquidity and diversification for investors and, finally, it gives new products and additional flow of volume and profits to financial markets for alternative investments (Kendall and Fishman 2000).

“Conforming” mortgages are usually packaged through the US Government agencies, as Fannie Mae and Freddie Mac (Agency MBS). “Non-conforming” mortgages (Subprime, Alt-A and Jumbo\textsuperscript{27}), instead, are packaged by big lenders or investors through investment banks that frequently are also underwriters. They place those non-agency MBS to final investors or in other CDOs. Rating agencies, committed to rate those


\textsuperscript{27} The Alt-A loans usually are the loans without full documentation; instead, “jumbo” loans are mortgages with an amount over $417,000.
securities, have really few information about the content of those CDOs and their riskiness, so they base their model over past data of comparable assets.

On one hand, this financial structure moves the risk from the upstream market to the downstream one, spreading it on a wide range of investors (Avgouleas 2008). On the other, the secondary market for subprime loans, through the sale of loans and the following securitisation, gives funds to fuel the whole system.

As shown above, moral hazard and adverse selection generally affect origination, securitisation and placement processes. The policy responses (see section 5) to the inherent weaknesses of this structure will be mostly focused on the upstream market, from which the risk is coming and spread all over financial markets and on the role of the secondary market generated by securitisation.

After the begin of the financial turmoil, the new issuance in US is made by agencies, while in Europe by private only for the retention by the issuer, which will use these securities in repo transactions with central bank, in a sort of support to financial institutions. However, the $9 trillion outstanding securitised products will be sooner or later circulating in secondary markets to restart the whole mechanism (see figure 7).

**Figure 7**

**Outstanding Securitised Products**

<table>
<thead>
<tr>
<th>2005Q1</th>
<th>2006Q1</th>
<th>2007Q1</th>
<th>2008Q1</th>
<th>2009Q1</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABS²</td>
<td>194.0</td>
<td>196.9</td>
<td>177.9</td>
<td>183.8</td>
</tr>
<tr>
<td>CDO²</td>
<td>315.1</td>
<td>319.9</td>
<td>254.2</td>
<td>272.6</td>
</tr>
<tr>
<td>CMBS²</td>
<td>148.0</td>
<td>145.0</td>
<td>141.5</td>
<td>141.5</td>
</tr>
<tr>
<td>RMBS²</td>
<td>1,089.6</td>
<td>1,108.7</td>
<td>640.1</td>
<td>780.2</td>
</tr>
<tr>
<td>WBS²</td>
<td>37.9</td>
<td>38.0</td>
<td>39.8</td>
<td>39.8</td>
</tr>
<tr>
<td>Total²</td>
<td>1,793.6</td>
<td>1,893.6</td>
<td>1,273.5</td>
<td>1,426.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2008Q2</th>
<th>2008Q3</th>
<th>2008Q4</th>
<th>2009Q1</th>
<th>2009Q2</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABS²</td>
<td>177.9</td>
<td>183.8</td>
<td>171.3</td>
<td>192.0</td>
</tr>
<tr>
<td>CDO²</td>
<td>254.2</td>
<td>272.6</td>
<td>284.0</td>
<td>297.9</td>
</tr>
<tr>
<td>CMBS²</td>
<td>141.5</td>
<td>141.5</td>
<td>139.2</td>
<td>138.4</td>
</tr>
<tr>
<td>RMBS²</td>
<td>640.1</td>
<td>780.2</td>
<td>848.4</td>
<td>1,089.6</td>
</tr>
<tr>
<td>WBS²</td>
<td>39.8</td>
<td>39.8</td>
<td>39.7</td>
<td>39.5</td>
</tr>
<tr>
<td>Total²</td>
<td>1,273.5</td>
<td>1,426.9</td>
<td>1,487.5</td>
<td>1,737.5</td>
</tr>
</tbody>
</table>

Source: Bloomberg (US & Europe), Pardee & Mar (US), Federal Reserve (US), Federal-Mac (US), Citigroup (US), JP Morgan (JPW), Loan Performance (XBP), Reuters (US), IFMA (Europe, US & Europe)

1. All volumes are denominated in euro. The US volumes were converted from dollars to euro based on the dollar exchange rate as at quarter end.
2. European ABS outstanding collateral types include residential, credit cards, loans (consumer and student), and other.
3. Non-ABS volumes are the total of CDOs issued after July 2007, regardless of entity of collateral, prior to this, only CDOs confirmed by major participants with known European participants.
4. Whole Business Securitisation is a securitisation in which the underlying assets are originated by the whole business (or a segment of) of a larger business.
5. Numbers may not add due to independent recording. Transactions in prior period numbers are revised to reflect changes in classification, refined selection methodology, or information updated to our data service. After the period quoted all changes to the data are included.
6. US Alt-Rating outstanding collateral types include subprime, credit cards, loans (home equity, equipment and student loans), CMO, and other. CDOs outstanding cannot be broken out within the ABS category.

Source: European Securitisation Forum
2.3 Homeownership Value

There are commonly three justifications for investing in homeownership (HUD 1995, Jacoby 2008):

1. Wealth accumulation and economic self-sufficiency;
2. Positive social-psychological states; and

A developed and efficient mortgages market is complementary to the development of a homeownership society.

The homeownership is the best tool for wealth accumulation ("total wealth") for moderate and low-income people (Sherraden 1991; Boehm 2004), who may not access alternative investment solutions because they have limited resources immediately available. A constant appreciation trend for home prices (increasing at least at the inflation rate) is indispensable condition sine qua non the homeownership cannot be considered as a wealth accumulation tool (Di et al. 2003). However, the house depreciation – background of the last financial crisis – testifies that investing in a house may involve risks. Homeownership may not result as a valid tool of wealth accumulation. In addition, the risk is much higher for borrowers who use specific solutions (hybrids) to invest on the house value. The stake associated with homeownership is high, especially for low and moderate-income borrowers; instead, incentives to rely on reputational mechanisms are weak. Due also to cognitive biases, the “game” is structurally designed to last for a short period of time (finite game). Furthermore, when interest rates are low the opportunities of alternative investments are low as well, inflating the bubble.

Low-income homeownership has a lot of appeal especially for those who intend to remain in their homes for a long time. Investing in a home on a so leveraged way becomes thus very attractive. Also during the stock market boom, at the end of the last century, housing equity represented the major wealth accumulation tool for non high-income borrowers. The high-return attractiveness hides relevant risks, though. In effect, the likelihood that low-income borrowers return to rent after homeownership is very high, so a better control of the risk and a more efficient credit market may increase the total welfare (Belsky et al. 2005). As consequence, the benefits from owning a home are high but delinquency and foreclosure are a relevant and dramatic risk (Dietz and Haurin 2003).


Hence, not only reputational mechanisms are efficient tools to help the construction of a long run game and to avoid the bad effect of the high stake linked to this market. It is also essential a regulatory intervention to deter specific negligent behaviours and supervisory improvements and to contain the impact of systemic risks. Dietz and Haurin (2003), besides, showed that the homeownership improves the political activity (strong empirical evidence on voting) and child outcomes, but it reduces people mobility.

In conclusion, homeownership may be used as a mean to take out equity from the home for other motivations. There are basically four reasons (Golding et al. 2008):

- Consumption of durables (or non–durables, in particular for low-income borrowers);
- Home improvements;
- Portfolio rebalancing; and
- Bill consolidation.

Ergo, in a context of houses price appreciation, the homeownership opportunity is appealing for many people who never thought they would be able to become homeowners.

2.4 Predatory Lending

The subprime mortgages market is not predatory lending. However, a clear definition of predatory lending does not exist. It may be defined as a system of illegal practices used in the lending market to exploit the borrower, generating a harmful rent seeking (Engel and McCoy 2002). A predatory lender does not assess the ability to repay the loan but the possibility to extract as much as possible from the borrower. These practices may be more frequent in the subprime market for two complementary reasons: the low financial education of the typical subprime borrower (unsophisticated) and the high complexity of the offered financial products. As just mentioned, when the stake is high, it is high the incentive to deviate from the game as well, especially when there are no reputational mechanisms involved. The usual reduced size of subprime lenders, the typical personal relationship between borrower and broker/lender, and the customized nature of the mortgage may promote the use of a “hit and run” strategy, as “steering” and “churning” behaviours. In the end, this incentive will induce lenders and brokers to originate as more loans as possible without accurately taking into account the related risk. The borderline between subprime and predatory lending is very thin. However, the negligent research of a harmful rent may be a sufficient way to find out

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whether a practice may be considered as illegal.

Finally, there is a clear trade-off between the benefits of eliminating predatory lending and the loss of welfare coming from a restriction of the high-cost but legitimate subprime lending for low and moderate-income borrowers

3. Main determinants of the borrower’s choice to get in a subprime mortgage

This section will describe the typical behaviours of a subprime borrower, which may influence the proper assessment of the decision to get in a risky financial transaction, as a subprime mortgage. The perception of the risk and the wealth accumulation are clearly the most important determinants of why borrowers end up with underwriting a subprime loan. In effect, they tend to partially take into account the risk related to mortgages and in particular to the interest rate (Paiella and Pozzolo 2007). Therefore, the analysis of subprime borrowers will move from the removal of the rationality assumptions to go into details of cognitive biases. We classify borrowers in two groups:

- Home buyers; and
- Investors.

Once removed the assumptions behind the concept of “rationality”, recent developments in behavioural economics will help us to better understand the asymmetries of information that structurally influence this credit market. Rationally, borrowers do not invest in information to fill the gap because it is extremely costly but “irrationally” they are not completely aware of their standing uninformed condition. There are five assumptions behind behaviour’s rationality (Debreu 1987; Korobkin and Ulen 2000; Varian 2006) that shape the rational economics and the utility maximization theory. These assumptions are:

A. Completeness (actors should be able to compare alternatives and to make an order);

B. Transitivity (if a player prefers A to B and B to C, so she would then prefer A to C; it is an assumption to avoid the intersection of the utility curves);

C. Invariance (moving on the utility curve should not change the utility if there is a switch between the 2 goods; the choice is not influenced by how it is presented or structured);

D. Monotonicity (the choice between two alternatives is apparently not influenced by their identical features; so, “more is generally good”; it draws the direction of the indifference curves);

E. Dominance (the mean of two choices on the same utility curve is preferred to
them; an alternative is not preferred to another if it has the same features but at least one of them is not as good as the others; this assumption defines the convexity of the utility curve).

The first three assumptions are enough to draw a utility function. Moving from these assumptions, decision makers make a cost-benefit analysis of different alternatives, choosing the optimal one (maximizing net expected utility)\textsuperscript{31}. Preferences are, in this way, considered fixed. It will be clearer in the next paragraphs as these assumptions are systematically violated.

The latest developments in behavioural economics play an essential role to describe behaviours that violate standard preferences. Thaler (1996) describes some ways in which “people” differ from the \textit{Homo Oeconomicus}. Their “bounded rationality”\textsuperscript{32} undermines judgment (of the risk) and decision making processes (as editing and evaluation). From the earliest tests on the violations of the expected utility theory (Allais and Ellsberg\textsuperscript{33}) and the earliest studies on the relation between psychology and economics to the latest insights of behavioural economics and finance there is a very long evolution of theories and thoughts that have built the foundations (with the


The rational ignorance, instead, occurs whenever an individual \textit{rationally} chooses not to acquire all the information needed to conclude a contract. As it was authoritatively observed, in a number of situations “the costs of becoming informed may exceed the benefit, resulting in rational ignorance of hidden traps in contracts that competition may not dispel”. See, e.g., See, e.g., Lucian A. Bebchuk & Richard A. Posner, \textit{One-Sided Contracts in Competitive Consumer Market}, 104 MICH. L. REV. 827, 827 (2006)

evidence on cognitive biases) of a new way to interpret human beings' behaviours. The scope consists in making these “irrational” behaviours predictable, lowering information asymmetries and so transaction costs. The earliest foundations in Behavioural Law and Economics refer to the Coase Theorem and the initial allocation of entitlements (Jolls, Sunstein and Thaler 2000). The following section will clarify which biases may determine a different final outcome through the influence of the initial allocation of entitlements (endowment effect).

The market for subprime mortgages is particularly affected by cognitive biases. The mortgage contract, especially for individuals with low financial education, is really complex and deferred costs may complicate their estimation of the choice to get in a mortgage and the evaluation of the affordability of the financial transaction. This choice, moreover, could be affected also by “speculative instincts”, shaped by other biases.

3.1 Cognitive Biases: an overall analysis

There are three traditional principles in Law and Economics systematically violated by the human’s behaviour (Posner 1998):

1. The optimization behaviour;
2. The dominance of opportunity costs (on sunk costs) in decision making; and
3. The invariance of initial allocation of entitlements when transaction costs are reasonably low.

Three “bounded” aspects in the human’s mind determine a violation of these principles: bounded rationality, bounded will power and bounded self-interests.

People are not always “rational” in the sense that economists suppose. But it does not follow that people’s behavior is unpredictable, systematically irrational, random, rule-free, or elusive to social scientists.

(Cass R. Sunstein 2000, p. 1)

Therefore, we are going to analyse biases affecting the classic “rational economics” and to make them predictable. The “bounded rationality” as well should be a main subject of study for a deeper understanding of the subprime origination process. It distinguishes biases affecting judgement and decision-making.

On the judgment side, it is possible to identify several kinds of biases (Ulen and Korobkin 2000; Sunstein 2000; Jolls 2007).

First of all, a self-serving bias affects judgment when individuals face a matter with room

34 For an extensive analysis of cognitive biases in the investor protection field, see Avgouleas (2006).
for disagreement. They will tend to interpret information in a direction serving their own interests. This is a judgment error, a distortion of people’s perception, for instance, of what is fair. This self-serving assessment can impede negotiations and it might affect people’s perception of social norms, in particular what is “moral” in credit markets. This bias may promote “credit immorality”, irresponsible borrowing and the increased use of defaulting (“walking away” from the contract) to get out of a mortgage, which is better explained in section 3.2.1.

Secondly, the prospect theory (theory violating the axiom of context-independence) also characterizes judgment behaviours. Anchoring and adjustment, for instance, shape the probabilistic assessment because people frequently fail to “adjust” their assessment from pre-existing cognitive anchors or reference points. For instance, the borrowers’ choice to get in a mortgage with adjustable rates (ARMs) may be “anchored” to a long period of low interest rates and home price appreciation. This behaviour gives a more relevant role to sunk costs in the biased decision, in order that if I put more efforts and money it is more difficult to move from it (rent-to-own behaviour). There are two effects violating the assumption of context independence: the compromise and the contrast effect (Kelman et al. in Sunstein 2000). The former implies that the relative ranking of two options depends on the presence or absence of other options; a subprime borrower is a typical individual with few wealth accumulation options (liquidity constraints). This aspect would lead subprime borrowers to misperceive the real probability of default on mortgages because the homeownership is the only safe wealth accumulation tool for them. The latter effect, by contrast, implies that the same option is evaluated more favourably in case there are similar but more inferior options (e.g. consumer loans, credit cards), than in the absence of such options. Moreover, the prospect theory faces another source of error linked to the humans’ misperception of their knowledge and judgment imperfection. People tend to overestimate (to be overconfident about) the probability of an outcome if an example of the event has recently occurred, as result of an overconfidence bias. For instance, the steady growth of house prices over decades created an overconfidence bias that this trend would continue for an indefinite time, inflating the bubble and accelerating the collapse. Classical example is the stock market boom (“internet bubble”) and bust at the end of the last century.

Thirdly, the *optimism bias*\(^{39}\) involves the belief that good/bad things are more/less likely than average to happen to us. This bias is strictly linked with the self-interest and overconfidence bias above. The subprime borrower is affected by this bias especially when she has to consider a deferred-costs transaction like a mortgage contract. Consumers change current consumption with future consumption relying on a belief that the income in the following period will be higher. There is the perception that it will be more likely that she will receive a higher income in the next period.

For all the biases mentioned above, we may conclude that for a subprime borrower is better an egg (not so good; loan with no favourable terms) today than a chicken (uncertain) in the future (savings or inferior alternative solutions). Homebuyers frequently tend to overestimate also the correlation between past trends and future price movements on the house value (Case and Shiller 1988). If the overconfidence affected the judgment of the opportunity to become homebuyer through risky financial transactions, the optimism bias influenced the estimation of their default risk.

Finally, the *hindsight bias*\(^{40}\) is the tendency of actors to overlook the ex ante prediction that they made concerning with the likelihood of an event after learning that it actually occurred. This bias has particular effects in tort liability.

On the *decision-making side*, there are two important biases. Both behaviours are corollary of the prospect theory. Firstly, the reference point and framing effect influence the decision maker and the context of the final decision. Specifically, this bias is called *loss aversion*: an individual will value a decision differently if it is specified in losses instead of gains. In particular, if a decision is perceived as “losses” (or “gains”), relatively to a reference point, the same individuals will be risk-seeking (or risk-adverse). The figure 8 draws a new utility function, with 3 characteristics:

1. The origin is the reference point;
2. The shape of the function is concave for gains (risk-aversion) and convex for losses (risk-seeking);
3. The function is steeper for losses than for gains (people are more sensitive for losses than gains).

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An example is the use of the helmet on a motorcycle. People perceive its use like a choice between two losses (getting a fine [when prescribed by law] and getting injured in an accident), hence the driver is more risk seeking (higher probability of not using helmet). One of the reasons why in many countries there are very strict rules obliging motorcyclists to use the helmet is their likely distorted perception of the probability that the helmet may save their lives. In this view, before the transaction, the potential subprime borrower may be risk-seeking, as she is facing two losses: payment of a rent for the house; and possibility to purchase the first home with a riskier and costly financial transaction. After the transaction, the subprime borrower may be risk-seeking, as she is trying to skip the immediate high loss (house price depreciation and following negative value of the mortgage she is paying), thereby underestimating or voluntarily facing future potentially higher expected losses (foreclosure, homeownership loss, eventual deficiency judgment, etc). Therefore, borrowers experience relevant difficulties in handling uncertainty and risk.

In conclusion, the *endowment effect*[^36] is a bias mixing loss aversion and status quo biases. It proves that the invariance assumption of the Coase’s Theorem[^42] fails to describe the real bargaining process for entitlements allocation. The initial allocation of entitlements matters, due to the endowment effect. Moving from that reference point thus will always include a trade-off. Hence, the irrelevance of legal rules, recalled in some circumstances, is a claim that no longer holds. “Debiasing through law” (Jolls and

[^36]: See Kahneman and Tversky, supra note 36.

Sunstein 2005) is thus an important need for an efficient bargaining process. Market rules and legal rules can properly shape this process (Sunstein and Thaler 2003). Whether the initial allocation of entitlements is made through contract law, the default rules would create a reference point for the sense of ownership defined by the endowment effect. People would be less willing to contract around default rules. The reference point, as showed in figure 9, shapes the final outcome for the influence of the reference initial point.

**Figure 9**

In it would be indifferent to choose y or x (on the same utility curve). In r and r’, however, the individual will choose respectively x and y. In the subprime market the reference point of a lower income or a generally not wealthy position makes more attractive the homeownership, with more availability to take risks. The status quo bias backs these behaviours, leading low and moderate-income borrowers to accept very high interest rates and/or unfavourable terms, as not far from the perceived conditions for risky borrowers. This is not completely irrational but “predictably” irrational. Human beings do not have an internal value meter that tell us how much things are worth but they focus on the relative advantage of one thing over another, and estimate value accordingly (Ariely 2008). This is basically the reason why low-income borrowers with bad credit histories are less interest rate sensitive and are more willing to accept teaser interest rates.

### 3.2 Subprime Mortgages Incentive Structure

The subprime mortgage is a highly complex financial product with a multidimensional pricing structure. It defers to the future (amortization) the prohibitive costs of the consumption in the first period. Mortgages typically have two risks: risk of interest rate and risk of default. Interest rate risk (or market risk) is exogenous to the borrower’s choice and it is too complex for her to foresee the interest rates trend, at least in the long run (typical length of a mortgage is 30 years). The lender is typically charged for making forecasts about interest rates movements and suggesting the “best solution” for borrowers. The interest rate thus is just a term of the contract that borrowers use in order to make comparison between different offers. The disclosure of an annual
percentage rate (APR) may reduce the complexity of the product and it would be easier to understand for subprime borrowers. However, borrowers still experience difficulties to assess the risk of the financial choice and the quality of the offered product only with the disclosure of the APR (see section 5). Moreover, the interest rate indirectly influences the value of the collateral, in this case the value of the home. For instance, an upward movement of the interest rate increases the investments alternatives reducing the value of the home because less people get incentives to invest in homeownership (it is more expensive). Therefore, there is a negative correlation between interest rate and home prices. The interest rate in this way can have a double effect on the borrower’s mortgage: the effect on the monthly payment (in case of an increased interest rate for ARMs or decreased interest rate for FRMs, in term of opportunity costs); and the indirect effect through the home value depreciation or appreciation. Default risk, instead, is a risk that borrowers and lenders need to implicitly assess through an accurate evaluation of the product affordability (ability to repay) and suitability.

In a context in which the collateral requirements are low, the down payment is low (due to liquidity constraints)\textsuperscript{43} and there is a complicated mix of uncontrollable variables (job status, health, etc), it is indispensable having efficient tools to analyse risk, as well as more stringent underwriting standards.

In addition, a speculative aim in the borrower’s final decision may affect the ability to repay the loan, if pursued on an uninformed basis (low investments on information). This variable is an important element that confers further complexity to the product and the way to evaluate risk (in this case, especially for lenders). Therefore, the above mentioned aspects plus higher search costs, lower financial education, greater lack of transparency on the overall characteristics of the product and competition on terms between subprime lenders increase the difficulty to make the right choice when people try to deal with subprime lending.

The Truth in Lending Act (TILA) of 1968\textsuperscript{44} tries to address these issues with some disclosure requirements and reduces opportunities for misleading behaviours of the lender. A misleading behaviour may emphasize the role of low monthly payments and may hide the real APR of the whole operation. In effect, before coming to force the TILA regulation, the misleading role of advertisements was really important: lenders were mainly taking advantage of cognitive biases (framing in particular) on low-income

\textsuperscript{43} Traditionally, the greater the financial leverage (high LTV, low down-payment) the higher is the probability the borrower will eventually encounter financial problems; see M. Rothschild and J. Stiglitz, “Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information”, Quartery Journal of Economics 90, pp. 629-649, 1976; Avery, Bostic, Calem and Canner, “Credit Risk, Credit Scoring and the Performance of Home Mortgages”, FED. RES. BULLETIN, pp. 621-624, July 1996. However, there are some empirical findings showing inconsistency between high LTV and financial distresses; B. Ambrose and A.B. Sanders, ”Commercial Mortgage-Backed Securities: Prepayment and Default, The Journal of Real Estate Finance and Economics, Vol. 26, N.2-3, March 2003.

\textsuperscript{44} 15 U.S.C. § 1601 (a).
borrowers. The Act hence obliges lenders to disclose the APR for every transaction. However, the Act does not oblige to reveal the non-interest charges (fees), so variables influencing a correct and efficient decision-making process are still affecting the ability to repay of subprime borrowers\textsuperscript{45}. As it frequently happens, complex products are a great opportunity for predatory practices by lenders and brokers, who try to exploit the information asymmetries between them and the “irrational” and unaware borrower. The “irrationality”, fuelled by cognitive biases, affects the perception of borrowers’ ability to repay, which supports the decision to get in a specific financial transaction. As result, the perceived probability of own default would be much lower than the real one if in the end the real probability of repayment was more or less the same.

Finally, it should not be surprising if a person with a very low income (qualified as subprime borrower), for a long list of reasons (fluctuating income, no or low permanent assets, job changes, family structure, etc), would be heavily affected by short-term focus. Hence, relaxing underwriting standards in a pro-cyclical way could be very dangerous not only from an economic point view, in terms of systemic risk and financial stability, but also from a social point of view. Giving stable solutions for wealth accumulation would promote the social stability for the weakest and poorest parts of our society, helping to reduce conflicts and inequalities.

### 3.2.1 Riding the bubble: when the borrower “seems” rational

It is possible to identify two kinds of borrowers: the homebuyer and the investor. The former is the typical residential mortgage borrower. The latter is considered a rational and informed borrower because it uses a mortgage as an “option” on the value of the house (Deng et al. 2000; Cutts and Van Order 2005). If the house value consistently drops, borrowers will voluntarily decide to be delinquent and then prefer the foreclosure to the monthly payment.

For lenders, instead, it is very difficult to assess ex ante borrowers’ opportunism. In effect, there are several aspects favouring the growth of “mortgage walkers”\textsuperscript{46}:

- a. The changes in social norms and “credit morality”;
- b. The low costs of default;
- c. The constant house value appreciation; and
- d. The use of non-traditional mortgage products.


\textsuperscript{46} Nicole Gelinas firstly thought about this definition of investing borrowers, see “The Rise of the Mortgage “Walkers”, \textit{Wall St. J.}, February 8, 2008.
The transformative changes in cultural attitudes and social norms have been testified by the reduced deterrent role of foreclosure and bankruptcy procedures. As showed in figure 10, the non-business bankruptcy filings largely grew between 1990 and 2005, as the cost of bankruptcy was very low, while borrowers may use it to get out from an inconvenient financial situation.

**Figure 10**

![Non-business filings for bankruptcy](image)

Source: US District Courts

After this period, in 2005, the Congress approved a reform to avoid the abuse of bankruptcy procedures to get out of the debt. The broad drop in filings in 2006 and 2007 shows how the use (“abuse”) of these procedures was diffused. In the 18th century who defaulted was considered like a criminal, but since 1970s, with the deregulation of interest rates, the consumer credit industry experienced a lessening of “credit morality”. Defaulting on your own mortgage was and is still an important alternative to get out of a costly and risky financial transaction. The costs of default, therefore, play a relevant role in providing incentives for borrower’s opportunism. Before the subprime crisis, the borrower-investor “rode” the house prices bubble until she could extract benefits from the homeownership. When the home value fell and the direct and indirect costs to refinance the mortgage were too high (increased interest rate), many of these borrowers voluntarily decided to default, filing for bankruptcy. There is currently a widely diffused practice to leave the key of the house in the mailbox for the lender that

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47 This reform establishes a new “means test”, to limit the use of the Chapter 7 to those individuals whose income is presumed insufficient (below the State average) to repay their unsecured debt in 5 years; see Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23, 2005.

is going to take back the home and to sale it (jingle mail; Zywicki and Adamson 2008). In effect, the high costs for lenders to bring a suit against every single defaulted borrower and the presence in many states of anti-deficiency laws\footnote{See \url{www.foreclosurelaw.org} for the full list of States with anti-deficiency laws.} reduced direct and indirect costs of default for these borrowers. Foreclosure and bankruptcy procedures ideally should imply higher costs than the value of the mortgage for borrowers. In reality, there is a probability to be prosecuted and that the costs of defaulting will end up to being higher than the value of the mortgage. However, there is a rational (for lenders) and “irrational” (for borrowers) explanation, which distort the perception of the costs of default. It is rationally low the probability that lenders will bring a suit against borrowers to get other resources from an already low or moderate-income borrower. The borrower thus faces two losses: the negative equity on the homeownership (and the higher monthly payments absorbing more income in the future) and, on the other side, a foreclosure procedure that occasionally can bring to very bad outcome for a long period (deficiency judgments, etc). As described above, when an individual faces two losses becomes more risk-seeking and still the most risky solution theoretically is the delinquency and then the foreclosure (for the potential costs she might bear in the long run, also in terms of restricted use of constitutional rights). This may be considered as a case of loss aversion.

**Figure 11**

![Yearly mortgage payments by categories](image)

**Source:** Federal Reserve Board, *Handbook on ARMs.*

In conclusion, the diffusion of non-traditional mortgages product increased the risks in the system. Almost 60% of mortgages (Barth et al. 2007c) are directly influenced by interest rate trend and it has been progressively reduced the use of plain vanilla loans, favouring even more the complexity of mortgages’ characteristics. Excluding the traditional ARM, there are hybrid types of loan and not-typical ARMs\footnote{For a detailed description The Federal Reserve Board, *Consumer Handbook on Adjustable-Rate Mortgages*} (see figure 11). It
is possible to arrange different solutions in relation to the specific willingness to pay in the first period of payment. In effect, it is also possible to design solution with negative amortization for a certain period, which means not even paying all the due interests on the mortgage. The 2/28 or 3/27 (fixed 2 or 3 years than adjustable rate), instead, are widely diffused between subprime borrowers.

In addition, there are several non-traditional products favouring speculative investments. The interest-only payments loan permits to pay in the first months only the interests. Therefore, the most interesting is the payment-option loan. It allows to choose every month between four kind of payments (Federal Reserve Board 2006; Duncan 2007): an amortizing payment on 15 years maturity; an amortizing payment on 30 years maturity; an interest-only payment; a minimum payment based on a start rate below the fully indexed accrual interest rate (this means negative amortization). Using these new financing tools increases the financial risk, thereby changing in some cases the “natural” aim of purchasing a mortgage (homeownership).

Figure 12

Foreclosure filings on Subprime Mortgages

Source: Barth et al. 2007a; Author's estimation (2007 and 2008).

For all these reasons, the borrower would see a mortgage like an option on the net value of the house. On one hand, he/she voluntarily fills the foreclosure form for the home if the interest rates soar and the value of the house declines or if anyway the expectation on house value will be negative. The figure 12 and 13 show the soaring foreclosure rates, also for prime mortgages, as result of the relevant drop in the home value and resources for new investments. On the other, a good part of borrowers would refinance the mortgage, holding the investment, if interest rates fall and house prices increase.

For an opposite position that partially recognize the existence of the investor-borrowers (for the existence of shelter services allowing to do not give up the capital gains of the complete mortgage repayment) but do not explain why these risky financial products exist, see Amy Crews Cutts and William A. Merrill, “Intervention in Mortgages Default: Policies and Practices to Prevent Home Loss and Lower Costs”, Freddie Mac Working Paper, No. 08-01, March 2008.
Figure 13 clearly shows us that the number of foreclosures skyrocketed when the value of the home declined and the traditional reference interest rate (30 years mortgage prime fixed rate) slightly started to rise again from 2003 and 2006\(^5^2\) (see figure 3). Although the majority of borrowers suffered a payment shock (figure 14) which induced to an involuntary default, due to higher monthly payment and stricter underwriting standards, there is a relevant part of these borrowers voluntary defaulting on the house depreciation trend (or expectations). They decide to refuse the payment shock (value of the house lower than residual mortgage to pay) and to get out of this expensive financing tool. As said, the reaction process is even more favoured by low costs of default. The home value trend follows the similar process for the inflation rate: variations of interest rates modify the inflation rate expectation and indirectly influence the real consumption, before the upward reset.

We can write an incentive constraint for the borrower. It will be equal to:

$$H-C(i)-d > D-H$$

where \(H\) is the value of the home, \(C(i)\) is the mortgage value that can change consequently to its type (FRM, ARM, Hybrid, etc) and \(d\) the the down payment. Fees can be separated and included in the down payment or they can be included in the interest rate (pooling). On the right side, the costs of default \(D\) include costs of foreclosure and bankruptcy (also lawyers’ fees and psychological worries), the residual mortgage amount to pay, costs for future borrowing (with a worse credit history). The assumption is that the intrinsic value of the homeownership for the borrower is equal to the value of the home in that moment. When the home equity \(H - C(i) - d\) is higher than the expected losses \(D - H\) there is a clear incentive to repay the loan until its maturity. When the interest rate move upward the inequality can be the opposite, giving incentives to the investor-borrower to default. In this case, \(C(i)\) increase and \(H\) decrease. There may be default when the expected benefits are lower than expected losses. Also increasing \(D\) too much there can be over-deterrence, inducing people to reduce investments in

\(^5^2\) In 2009 the projected number of foreclosures on all mortgages is around 3.9 millions (Source: Bloomberg News, see http://www.bloomberg.com/apps/news?pid=20601103&sid=a6aLu9zxbcM).
homeownership. An efficient level of D (D*; default costs) can address the equality above, moving out of the market the investor borrowers (with a level of H – C(i)*). The formula can be:

\[ D = (R + F + pDef + \varepsilon) \]

where \( R \) is the residual amount of the mortgage to pay, \( F \) the foreclosure costs (attorneys fees etc), \( pDef \) the expected losses from a judgment for deficiency and \( \varepsilon \) is the residual cost (psychological costs and costs of future borrowing). It is quite clear that D was perceived as very low (and probably it was). First of all, the perceived (and real) probability to get in a judgment for default is very low. Secondly, the relax of underwriting standards for getting a loan and the following extension of credit also to non-creditworthy individuals may have unjustifiably reduced worries (and perception) about the higher cost to access credit in the future with a bad credit history. R was perceived very low for the risk-seeking borrowers, due to the loss aversion described above. In this way, D should move together with the value of the stake (H-C(i)-d) to provide borrowers with the right incentive to avoid risky subprime mortgages, even though the potential profits are extremely high (a deficiency judgment may help this process).

If default costs are sufficiently high, a separating equilibrium may occur (Harrison et al. 2004). The high-risk borrowers will apply for low LTV (loan-to-value) loans to reduce the expected losses of defaulting. The low-risk borrowers will choose a high LTV loan to signal their enhanced creditworthiness. The trade-off for them stands between the benefits of revealing their nature (lower interest rate) and the losses of asking a higher LTV mortgage (higher interest rate). The benefits should prevail because lenders can control better risks and maybe reward more borrowers for revealing sensible private information.

### 3.2.2 Prepayment Penalty Clause: “Ghost busting”

Before going into details of fees and their role in the provision of residential subprime mortgages, it is crucial to explain the function of the prepayment penalty clause in the subprime mortgages. Prepayment usually occurs when interest rates fall and the borrower wants to refinance her loan at a lower interest rate. Therefore, the possibility to refinance the mortgage and to continue to reap the benefits of homeownership is linked to the costs of prepayment. As some other extra fees, the price of the prepayment penalty is not included in the APR (see section 5.1.1).

This clause is reasonably frequent in the subprime market because lenders usually encounter high servicing costs. First of all, although they are gradually being moved in fixed initial fees (also for the increasing risks of prepayment and defaulting), these costs are so high that they need to be diluted in the monthly payments. If the borrower decides to repay before a certain date, lenders are going to face high losses on upfront costs (Zywicki and Adamson 2008) and the opportunity costs of having invested those
resources in an alternative financing tool with lower interest rate. Secondly, prepayment penalties assure a more reliable stream of income for investors in pool of mortgages securitized in the secondary market (Duncan 2007). Lenders, in this way, can sell a product more reliable to investors. Therefore, borrowers get a lower interest rate if they accept the clause.

Turning on the negative aspects of the prepayment penalty clause, there are mainly two things to do in order to avoid that the borrower gets stuck in the mortgage at high interest rate without any possibilities to get out of it. Firstly, the penalty should be optional in the mortgage and clearly disclosed to the borrower. Then, the validity of the clause should not exceed a limited period of time. The final rules on disclosure, written by the Federal Reserve System to modify the Regulation Z (TILA)\textsuperscript{53}, establish stricter rules on prepayment penalty clause than those ones proposed. First, the regulation prohibits prepayment penalty clause if payments can change during the four-year period following consummation. For other mortgages, these final rules limit prepayment penalty periods to a maximum of two years following consummation, rather than five years proposed\textsuperscript{54}.

For some authors, the prepayment penalty could be also forbidden because, advancing not so clear economic justifications (the subprime market is already a high-profitable market), it increases the costs of the credit (Essene and Apgar 2007) when competition can internalize the impact of these relatively high increments in servicing costs when lenders deal with extending credit to low-income borrowers. However, eliminating prepayment penalties would reduce the flow of private information from the borrower to the originator lender. In effect, lenders are not able to fully assess, with their risk-based pricing system, the potential opportunistic behaviour of the borrower, as described above. Therefore, for other authors, it is probably more efficient to get lower interest rates with prepayment clauses (Elliehausen et al. 2008), so permitting the borrowers’ private information to circulate, perhaps revealing crucial information on their real risk (separating effect; see section 2.1). Drawbacks of maintaining the clause are related to abuses, as fixing long clause periods or using this clause with ARMs payments in order to put borrowers in a highly inconvenient position unless they pay a high penalty to get out.

\textsuperscript{53}The approved final rules are even stricter than the rules proposed in December 2007 by the Federal Reserve Board and published for public comments (available on \url{http://www.federalreserve.gov/newsevents/press/bcreg/20071218a.htm}); these rules are effective from the 1\textsuperscript{st} October 2009; see Federal Reserve System, Final Rules on Regulation Z (TILA), Docket No. R-1305, 12 CFR Part 226, July 14, 2008 available on \url{http://www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm}.

\textsuperscript{54}It is clear the pressure exercised by consumer associations, see \textit{id}. p. 70.
4. The incentive structure of intermediaries: moral hazard and adverse selection

Between borrowers/consumers and investors in securitised products (e.g. RMBS) there is a complex web of relations, which involves several and diverse market participants at different stages. As for the investor-broker-dealer relationship in securities regulation, also in the subprime market there is a fiduciary duty that should be formally recognized. So lenders or brokers should be obliged to act or give and advice for the benefit of the borrower within the scope of their relationship. In effect, the fiduciary relationship exposes a beneficiary/principal to two distinct types of wrongdoing: first, the fiduciary may misappropriate the principal’s asset or some of its value (negligence); and second, the fiduciary may neglect the asset’s management (failure to perform). In US, the fiduciary duty can be recognised in two kinds of situations: when the contract explicitly recognises a fiduciary relationship (e.g. principal-agent); and when specific circumstances surrounding the transaction and the relationship occur (Unseth, 1997). “Trust”, “confidence” and “influence” are the keywords to ascertain the existence of a fiduciary duty. The broker-borrower, the lender-borrower and secondary lender-borrower (when there is a broker in the middle) relationships do not involve a general legal fiduciary duty (Hunt, 1994; Hanning 2008). However, this fiduciary duty can emerge if specific circumstances modify the nature of the relationship, even though in case of bank-borrower relationship a fiduciary duty could be recognised as intrinsic to the relationship (Hunt 1994). For instance, the lack of education or cognitive biases may increase the vulnerability of the weakest party, imposing a fiduciary duty in order to balance the relationship. Also in the relationship between secondary lender and borrower, fiduciary aspects can be highlighted. In effect, the US case law has already recognised the insurer-client relation as implying fiduciary duties, coming from trust and confidence. Hence, this conclusion can be drawn for secondary lenders as well, as
the proofs of vulnerability and confidentiality of the borrower are particularly evident.

The subprime borrower’s characteristics (described above) typically imply "a reposing of faith, confidence and trust"\(^64\) in brokers and lenders’ advices (and their product information) to choose the mortgage they think it would better fit with their risk profile. This can explain also why the number of brokers acting as agents is so high respect to the prime mortgages market. The payment of different kinds of fees for the service and the costs of a customized product, plus information asymmetries – due to cognitive biases and borrowers’ inability to evaluate a complex financial products – determine a contractual relation that creates a fiduciary duty between brokers/lenders and the subprime borrower, investing her past, present and future savings (as a principal in an agency relation\(^65\)). This duty should influence brokers and lenders’ behaviour and their expectations, producing also a deterrence effect (Huang 2003). The contract often is incomplete for the high costs of specification and monitoring\(^66\), as both parties withhold private information. In effect, as explained above, on one side risky borrowers have no incentives to provide info more than needed to get a mortgage. On the other side, the absence of a general fiduciary duty for broker/lender does not necessarily imply any responsibility in case of breach in the provision of the mortgage\(^67\). The recognition of a fiduciary duty will represent the background of the policy responses addressed in section 5, plus a general duty of “fair dealing”\(^68\) against deceptive practices.

### 4.1 Brokers

Brokers represent the first ring of the chain, the agents who procure customers for originator lenders. They usually are “individuals or firms that bring borrowers and lenders together for the purpose of loan origination”\(^69\). In 2004 their number was over 53,000 firms (not clear the number of individuals), which had placed around 58% of all subprime mortgages (Apgar and Fishbein 2005). Ideally, the broker’s function is to

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\(^67\) The three typical breaches of fiduciary duty pursued by brokers/lenders in the subprime market consist in practices failing: to disclose loan terms; to disclose loan fees; and to provide best possible loan terms (Unseth, 1997).


reduce the information gap between lenders and borrowers, who suffer the complexity of the financial product. Most of them, then, exploit their personal relationship with borrowers and the commercial relations with originators in that specific area, to bring parties together and close the deal. Therefore, brokers provide low-income borrowers with two services:

- Product information;
- Access to high-cost lending.

In this way, brokers are the only reliable source of information for those financial low-educated people, who usually accept their advices (Jackson 2002). For this and other reasons (see previous section), this relationship involves several circumstances that create a fiduciary duty for brokers towards borrowers.

On the market side, moreover, brokers face an aggressive competition on customers and not on mortgage terms, as the complexity and customisation of the product reduce ability to compare (and increase switching costs), thereby creating a “lock-in effect” for final customers. Then, the absence of regulation permits brokers to exploit their influential contractual power to charge high costs on borrowers or to push them accepting unfavourable loan terms. They actually exploit their contractual power with specific categories of borrowers that have no sufficient financial education to approach this market. In effect, brokers often have personal relationships with their customers and they follow every step of their financial decisions, due to their lack of financial literacy (Zywicki and Adamson 2008).

In the remuneration, independent brokers provide lenders with new customers in order to increase commercial relations that are based only on volumes. In effect, they are rewarded from borrowers with two fees. An origination fee, mainly for the access to new financing resources and advices they provide to them. The second fee, which is strongly debated, is the yield spread premium (YSP). This fee links its size to the final interest rate charged to the “irrational” borrower. For instance, if the market rate for a subprime loan (considering the borrower’s characteristics) is 9%, broker gets a higher fee for every basis point she succeeds to charge over the average rate. Since borrowers - as explained above - are originally less price-sensitive because their attention is almost exclusively focussed on getting the approval, brokers can easily led them to accept interest rates quite above the average. In this way, the YSP may undermine the risk-based pricing system, since there is no real evaluation of the ability to repay. The subprime meltdown showed how a gradual detachment of borrower’s ability to repay from the primary risk assessment can harm in the long run the entire chain, from borrowers and lenders to final investors in the secondary market.

In addition, brokers make very low investments in their activity, so they are almost “without any skin in the game” (Gramlich 2007b). They do not bear any liability for missing repayment due to an inappropriate and distortive recommendation of the
broker for a specific financial transaction. Hence, with a so large stake on the table and without any reputational mechanisms, brokers have “steered” borrowers (in particular “marginal borrowers”) towards higher-cost products even though they could apply for a more competitive loan. Frequently, brokers may also help borrowers “to fit” in the proprietary scoring systems and the underwriting requirements with unclear practices (Bitner 2008).

The moral hazard problem, described in a better way in the next section, arises because one party tries to exploit the informational advantage for its own profit. It is an informational problem related to the provision of an experience and credence good, as we see a mortgage. In addition, also an issue of adverse selection may emerge due to this asymmetry of information over fees and the Yield Spread Premium. The brokers’ “pooling effect” in borrowers’ evaluation pushes the prevalence in the market of brokers who rely more on YSP remuneration and less on origination fees (“good” brokers?). For the peculiarities of subprime borrowers, in effect, a one-shot fee will impact more than the equivalent diluted in a higher interest rate. However, the increased use of the YSP would create more distortive incentives, as good borrowers will use YSP until the rate is suitable for borrowers. Hence, the “good” broker then would rely more on origination fees (higher price) and less on YSP fees, in which “steering” and “churning”70 practices may dominate the transaction, in order to increase the remuneration (“bad” brokers). Even though the YSP can still be a good tool if brokers are guided by reputational mechanisms (Duncan 2007), liability rules and supervisory systems for brokers, if they deviate from the right path, would increase costs, in particular to implement mechanisms of control on YSP. Then, the positive impact on adverse selection - created by the YSP – may not be relevant.

Several factors explain this market failure: the lack of any supervision by the market and institutions over the brokerage system; the scarce transparency on fees and YSP (as consumers are not really able to evaluate brokers’ behaviour); the bad structure of incentive (by the YSP); the absence of conduct of business rules (which favour “steering” and “churning” issues; Pacces 2000); the absence of any liability and any specific investment in brokers’ activity; few possibilities of “disintermediation”, as it would be extremely costly and not really feasible. Therefore, brokers represent almost the only mean for low-income borrowers to access the high-cost credit market.

70 Churning is a legal term imported from securities regulation and defined by SEC as an “excessive buying and selling of securities in your account by your broker, for the purpose of generating commissions and without regard to your investment objectives”, [http://www.sec.gov/answers/churning.htm](http://www.sec.gov/answers/churning.htm). It was firstly judicially defined in *Hecht v. Harris Upham & Co.*, 430 F.2 days 1202 (2nd Cir. 1970).
4.2 Mortgage Originators

Mortgage originators (or simply originators) represent the connection point between the origination and the securitization process. Their role is to generate new loans and to sale them on the secondary market in order to fuel the entire market for RMBS, and increase it with the resources coming from the market. As explained above, the provision of experience (or credence) goods for low-income borrowers creates issues of moral hazard and adverse selection, due to information asymmetries. Subprime originators are basically small State-chartered companies without any reputational capital and low specific investments in the infrastructure. A majority of them, in addition, uses warehouse lenders to immediately get money for subprime lending. Important financial institutions in fact avoid entering this market for reputational concerns that these small companies do not have. In effect, the market apparently was aware of the riskiness coming from this specific area of credit markets. Subprime borrowers are usually out of the traditional credit market and bring with them greater risk of default than prime borrowers.

As described above, originators establish a (non “pure”) fiduciary relationship with borrowers who “invest” their future proceeds in complex and customised financial products like subprime mortgages. Originators, like brokers, therefore provide not only lending services but also advice services following and frequently inducing borrowers to make refinancing operations. They ought to furnish efficient advices to let borrowers consciously make investment decisions that better fit with their specific risk, taking into consideration their cognitive biases. Besides, in their customers’ risk evaluation, originators make use of automated underwriting systems (based on credit scores) that do not take into account the risk “relativity” and cognitive biases affecting in particular low-income borrowers. In the last years, many subprime lenders have developed a proprietary credit score system with automated underwriting systems that contributed to weaken the quality of risk evaluation. This underwriting system enhances the original adverse selection problem between borrower and lender that causes credit rationing, because it tends to standardize the estimation and the subsequent risk estimation. Hence, standardised access and risk/price evaluation create an obvious pooling effect for borrowers. Lenders’ assessment of the real risk will be further harmed, increasing artificially the interest rate and excluding low-risk borrowers from the market.

The presence of the secondary market for mortgage loans, due to the securitisation mechanisms, fostered moral hazard and volume-based incentives to originate, highlighting issues also on the supply-side71. This problem affects price and quality of transactions. The striking divergence of interests between brokers, originators and

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71 So far, we have exclusively focus on the demand side and the borrower’s aspects that determined a specific contractual design for subprime mortgages.
loans packagers, and the two final users (borrowers on one side and investors on the other side of the chain), creates not enough incentives to report complete and accurate information needed to make good decisions, with harmful effects on decision makers and so for the social welfare (productive resources are wasted). Regarding quality, when users cannot easily monitor it, there is a tendency for originators to provide borrowers and investors with poor quality financial products and to put little effort, care or diligence in services (Milgrom and Roberts 1992). Once again both lenders and society are harmed. In this way, complexity and moral hazard may produce a harmful “rent-seeking” behaviour. Strong incentives to produce subprime loans prevail, spreading harmful behaviour in this credit market. In effect, with a securitisation mechanism which allows the complete transfer of risk, lenders are exclusively interested in the origination of mortgages (volume-based incentives)\(^2\), while they do not care about quality as they can completely discharge risk selling loans to other lenders or directly to investors through securitised products (e.g. RMBS). There are weak mechanisms of monitoring since the lack of supervision and the complexity by external resources to evaluate the financial transaction.

As already taken into account, the constant home price appreciation also favoured the sustainability of this harmful process. Lenders gambled on the value of the collateral, relaxing underwriting standards and relying on the “insurance effect” of the secondary market and the credit expansion (transferring risk and freeing new resources; Dell’Ariccia et al. 2008).

*Although the development of the secondary market has had great benefits for mortgage-market participants, [...] in this episode the practice of selling mortgages to investors may have contributed to the weakening of underwriting standards.* (Bernanke, 2007)

The secondary market and collateral (home value) have become reasons of excessive risk-taking behaviours, instead of tools to transfer risk without affecting the resilience of the whole infrastructure. Hence, it becomes rather irrelevant whether or not a borrower is able to repay her loan in the long run. The moral hazard issue fosters “steering” and “churning” practices (see footnote 3). Churning may be more frequently related to economically unjustified origination or refinancing operations. The better-informed lender churns her clients’ portfolios, encouraging them to refinance more often the financial transaction she advises (so called “loan flipping”; Engel and McCoy 2002). In this way, they increase the revenues due to fees over the new generated services, especially if lender succeeds to convince subprime borrowers to get in a mortgage with particularly unfavourable prepayment penalties (making distortive use

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\(^2\) Some authors argue that in the end agency costs were not that large, as many agents (as big lenders and government agencies) retained substantial positions, as loan or securitised products, on their balance sheets; see Gary B. Gorton, “The Subprime Panic”, *NCER Working Paper 14398*, pp. 28-31 (October 2008) (available at www.nber.org/papers/w14398)
of this relevant tool for information revelation).

The proliferation of fees in fact may be a highly impacting way to reduce lenders’ exposure, as these further costs may represent an alternative to higher interest rates and high costs of servicing subprime borrowers. However, this situation is particularly related to the presence/absence of competitive market conditions. Nevertheless, there are two rational reasons to consider efficient the proliferation of “separated” fees (instead of pooling them in the APR) when there are important moral hazard concerns (Bar-Gill 2008):

− Separating services prices allows a better tailoring of the product to borrowers’ preferences;

− Separating fees from interest rate help a shift towards a more efficient risk-based pricing approach and eliminate the systematic cross-subsidisation through supporting high delinquency and foreclosure costs with higher interest rate also for less risky borrowers.

It is extremely difficult for subprime borrowers to understand the APR value, when it completely internalise (in an “obscure” and ambiguous way) a long list of fees of which they are not able to evaluate the suitability (bounded rationality and rational ignorance). Pooling fees, therefore, implies higher interest rates that defer costs to the future, attracting riskier borrowers. In the credit market, contrarily, less risky borrowers are more sensitive to interest rates changes (Stiglitz and Weiss 1981) and fees pooling leads low-risk borrowers (the majority, relatively to the market) to partially entry the market. A “separating fees” scenario thus would reduce the interest rate and the amount of deferred costs to the future. This would imply higher down payment, without affecting the LTV ratio but only the interest rate (lower). Specific separated fees may avoid the uncertainty coming from higher deferred costs, inducing better screening of borrowers. The final result will be clearer transparency, which also determines conditions for more competitive markets, thereby allowing competitors to better compete on fees and conditions of the mortgage and not for new customers a such, in order to exploit their influent contractual power (due to informational gaps). Actually, competition focused on customers intensifies moral hazard, relaxing underwriting standards to permit a higher rate of origination.

In conclusion, the “insurance effect” of the secondary market for subprime mortgages (and related churning problem), the absence of reputational mechanisms and the informational asymmetries heavily impact on the originator’s contractual relations with borrowers (in the origination) and investors (when the loans are packaged and sold to the market). In addition, overreliance on ratings by final users also affected the infrastructure, as this phenomenon did not promote incentives to invest on internal mechanisms of due diligence (but it has been used as a substitute), which could be helpful to better understand the real quality of the assets pool (IOSCO 2008). Ergo, the subprime market undoubtedly needs regulatory and non-regulatory responses.
5. Some Responses: how does the policy-maker may shape the subprime market?

The fast and huge growth of the subprime market has shown, as often happens with new deregulated markets, a clear-cut need of some kind of intervention. The imperfectly informed decision-makers and conflicting interests between participants have created distorted incentives and following incompleteness of contracts. The market failure of cooperative relations may set up a case for regulatory intervention (Ogus 2004), “debiasing through law” (Jolls and Sunstein 2005).

Authority arises from the technological and social limitations of cooperative systems on the one hand, and of individuals on the other.

(Barnard C., The Functions of the Executive, Harvard University Press, Cambridge, p.184, 1938)

The insufficient number of marginal consumers able to “shop around”, thereby correcting the market (Schwartz and Wilde 1978; Hynes and Posner 2001), may call for a more paternalistic intervention over market participants, but respecting the freedom of choice (Sunstein and Thaler 2003). The original attempt by the most informed party to exploit private information undeniably undermines this market for subprime mortgages. The implicit systemic risk - triggered by its financial instability - needs clear policy responses.

Nevertheless, the authoritative intervention will inexorably impose losses on some individuals, but there is a good chance that the intervention will be Kaldor-Hicks efficient (aggregate losses lower than aggregate gains; Ogus 2004). The intervention thus should take into consideration risks of overregulation and costs borne by lenders, brokers and society to avoid the inefficient credit rationing. It should be also considered risks of a soft regulation approach, since cognitive biases affect also regulators with also risks of excessive paternalism (Avgouleas 2006).

The next paragraphs therefore will describe three kinds of interventions. First of all, a regulatory intervention based on conduct of business rules (coming from the recognition of a fiduciary relationship) as, for instance, mandatory disclosure (reduction of complexity) and suitability test. Secondly, an intervention to establish reputational mechanisms and self-regulation processes. Last but not the least, it is needed an extension of the supervision to State-chartered companies, for macroeconomic and financial stability concerns.


74 See Avgouleas (2000).
5.1 Regulatory Intervention: looking “over” the crisis

As we largely discussed above, the costs for subprime consumers to acquire sufficient information in order to fill their informational gap about the services received from the originators affects the efficient decision-making process. This problem thus does not shield parties from classical informational issues as moral hazard and adverse selection. Third-party externalities, market power and bounded rationality do the rest (Hermalin et al. 2007). Informational problems have the big responsibility to prevent markets from achieving a first-best solution. An efficient regulation of the subprime market may definitely increase the social welfare. In effect, market forces are not able or have not enough incentives to positively address bounded rationality problems with a structure of incentives able to deter the exploitation of borrowers’ weaknesses from other market participants.

Furthermore, it is essential to intervene, taking into consideration the limited role of alternative solutions (credit card, personal loans, etc) to foster product competition between originators and other financial entities.

Every regulatory intervention involves public and private interests. Concerning with public interests, regulation may reduce information asymmetries between borrowers and brokers/originators, and between originators and investors in the secondary market, due to the characteristics of experience and credence good of subprime mortgages. Regulation may also reduce the level of negative externalities created by the misallocation of resources, which may harm the whole society. In fact, subprime borrowers may be steered to get in a mortgage that they are not able to repay, thereby triggering socially and economically expensive procedures, as foreclosures and bankruptcies that contribute to spread negative externalities on entire neighbourhoods and areas. The availability of “safe” credit for low-income borrowers may improve their wealth accumulation and, in this way, the society’s wealth (indirectly performing also distributional motives, typically charged on market forces75).

About private interests, a regulatory intervention can weaken incentives to adopt harmful rent-seeking practices by brokers and originators, as result of the exploitation of their contractual power (and informational advantage). Therefore, they may regularly compete on the product and improve their margins. This likely outcome may finally reduce adverse selection and moral hazard coming from the complete transfer of the risk thanks to the secondary market for securitisation. Hence, the regulatory

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75 It is a consolidated thought in Law and Economics that legal rules should not directly pursue distributive target, which is a goal of the tax system; see Louis Kaplow and Steven Shavell, "Why the Legal System is Less Efficient Than the Income Tax in Redistributing Income", Journal of Legal Studies 23, pp. 667-81, 1994; famous example is the Italian case of the “equo canone”; legal rules fixed the price for renting a house, fostering as result the black market for house renting; see Ireneus L. and M. Van Hees, “The Italian Housing Market: Its Failures and Their Causes”, Urban Studies Journal, Vol. 28, No. 1, pp. 15-39, 1991.
responses that are going to be described should promote an efficient risk-based scoring system, and promote best practices by players with “good” intentions. Mandatory disclosure requirements and simplification; a suitability test; and liability or mechanisms of retention will be the relevant responses. At consumer protection level, instead, the problems above are less strong, as large categories of consumers are protected, especially in Europe, in the access to credit by rules, with lower impact for their irrational behaviours or lenders’ malpractices. Finally, the primary need of homeownership guarantees a stable and secure flow of assets for RMBS issues, improving market efficiency and liquidity. The market is gradually starting again.

5.1.1 Mandatory Disclosure

One important regulatory tool to reduce the informational gap affecting borrower-broker-lender-investor relationship is a system of mandatory disclosure that helps to simplify the flow of information and to disclose hidden costs in a way that can help borrowers to have a clear understanding of the financial transaction. Disclosure may avoid some market failures, contributes to promote allocative efficiency and competition (new entrants may easily deliver their better price), and reduces the principal-agent conflict (Beales et al. 1981). High costs for borrowers of understanding or getting enough information, in order to efficiently support their financial decisions, cognitive biases and deceiving practices may lead subprime borrowers to promise to repay a mortgage that actually they cannot pay back. Rational and irrational reasons, as showed above, affect borrowers’ choices. The mandatory disclosure may be a way to give to borrowers “enough” information to choose and to stimulate their “rational spirit”, fostering their ability to “shop around”.

If those able to understand APR have “shopped around” to find the most favourable rate, some suppliers will have been forced to lower their charges, and the welfare gain might well have been sufficient to justify the cost of the disclosure system.
(Ögus 2004, p. 130)

At this point, what is “enough” for a subprime borrower becomes the crucial point. What does the crisis explain us is that the price disclosure is not sufficient to make borrowers completely aware of the consequences on her risk profile. Brokers and lenders have intentionally hidden fees and other costs in the APR or servicing costs.

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76 The Title I of the new US Mortgage Reform requires timely and complete disclosure of: 1. Comparative costs and benefits of each residential mortgage loan; 2. Costs of services provided by the originator […] 3. Conflict of interests between originator and borrower. In addition, it also foresees, before settlement, the disclosure of the level of protection of anti-deficiency laws for borrowers, in order to understand what happens if they are not protected by State laws and they get foreclosed. Finally, it prohibits the use of balloon payments. See, House of Representatives, H.R. 1728, Mortgage Reform and Anti-Predatory Lending Act, May 2009, Title I, Sec. 102, Title II, Sec. 206(c) and Title III, Sec. 302(b).

77 Marginal costs of getting information may be higher than marginal costs of new credit.
Therefore, it is surely not “enough” the disclosure of the APR that is an interest rate including points paid on the loan, any fees paid to the lender for making the loan, and any mortgage insurance premiums lenders would request borrower to pay (Federal Reserve System 2006). Prepayment penalties - frequently used in the subprime market and charged to borrowers who want to refinance or pay back a mortgage before the end -, late fees, returned check fees, title fees, taxes, license fees, appraisal fees and credit report fees are only some of the costs that are not by law included in the APR (McDonald and Thornton 2008). For instance, it is extremely complex for borrowers to calculate the size of the penalty from a formula and to evaluate the opportunity to move on another mortgage solution. Finally, the current APR disclosure, especially for ARMs, does not involve any disclosure of the trend of interest rates, monthly payments changes or estimations of houses prices variations. This been said, a mere disclosure of APR and monthly payments may be not enough or even misleading. For instance, two mortgages can have the same APR but borrowers do not know the distribution and the real amount of the fees (or they have not so easily to calculate them) to permit comparisons of the mortgage costs and to foster a competitive environment.

However, concerns may also arise from solutions as putting every fee in an all-inclusive rate (actually hiding them), which can be easier to understand but does not allow judging correctly the risk and the effective choice, plus it does not give enough incentives to lenders to invest in pre-contractual services and to give more than legally binding information. Therefore, there could be space to provide information in a misleading way inducing subprime borrowers to get in a high-risk financial product and increasing the opportunities of predatory practices. With this solution, brokers’ fees are not clearly disclosed as well and it is usually the borrower asking brokers the amount included in the APR, in order to compare it with other offers. Borrowers frequently have also to ask which kind of rate is applied (fixed or adjustable or hybrid solutions) and the amortisation of the mortgage with each solution.

Price transparency may be harmful in an oligopolistic context with homogeneous products (Motta 2004): as described above, the market for low-income borrowers is basically the opposite, as the risk cannot be made homogenous. Therefore, a clear price transparency would be beneficial for the market in terms of competition and consumer protection. Hence, a clear disclosure of all the fees (servicing costs of the mortgage) ex ante and an optional mechanism to dilute fees in the monthly payments or pay them in the down payment can be sufficient to make the product more understandable and to

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78 The new final rules on Regulation Z modifying the Truth in Lending Act (Federal Reserve System 2008) consider few modifications of APR disclosure and still the stricter regulation of HOEPA on disclosure have a limited range of action; see Home Ownership and Equity Protection Act of 1994, amending TILA by adding Section 129 of TILA, 15 U.S.C. § 1639 and implemented by Regulation Z, 12 C.F.R. §§ 226.31 and 226.32.

create conditions for a more competitive subprime market, as the number of lenders
and brokers is already high but segmented per area. In addition, limiting the impact of
the bounded rationality through the customisation of the information delivered to
borrowers who are going to choose a specific mortgage solution would be an efficient
and long run solution (Avgouleas 2006).

In conclusion, even though good disclosure requirements are essential, regulators
should not forget the risk of too high compliance costs and the following inefficient
credit rationing or higher entry barriers for new competitors. An overflow of
information for borrowers, moreover, may overwhelm borrowers’ cognitive abilities
and cause them to ignore it (Beales et al. 1981). For instance, the disclosure of insurance
premia (PMI) may improve competitive conditions in the market for private insurance,
and stimulate efficient market forces. Moreover, better disclosure may signal the quality
of the risk assessment, creating reputational incentives.

**5.1.2 Suitability Requirements: an “elegant” way out to lenders’
opportunism**

The limited consumer’s ability to monitor and to understand the quality of the financial
product may give incentives to lenders’ malpractices. There is an undeniable need for
promoting the convergence of parties’ objectives, aligning interests of lenders with
borrowers’ preferences (and avoiding lender’s opportunism). Therefore, there is a duty
on lenders to analyze their customers’ financial needs and risk profile (appropriateness), so to assess the suitability of the financial offer.\(^{80}\)

The duty of suitability rejects the prevailing paradigm of caveat emptor and
forces these providers [lenders] to internalize the harm that they cause when
they exploit information asymmetries to the detriment of customers.
(Engel and McCoy 2002, p.1334)

The fiduciary duty between brokers/originators and borrowers and the shingle theory
definitely implies a general clause of fair dealing.\(^{81}\) Consequently, in securities
regulation, there is an implicit duty to make an adequate investigation of investors’
suitability that involves a professional knowledge (“Know the security”)\(^{82}\) and a specific
“Know your customer” obligation\(^{83}\) (Hazen 2006). Therefore, there are basically three

\(^{80}\) Against the extension of suitability requirements to the subprime mortgages market for the higher
subjectivity injected in the risk-assessment process, see Duncan (2007); Mortgage Bankers Association,
“Suitability, Don’t Turn Back the Clock on Fair Lending and Homeownership Gains”, Policy Paper Series

\(^{81}\) See Note 47.

\(^{82}\) See Alton Box Bd. Co. v. Goldman, Sachs & Co., 560 F.2d 916, 922 (8th Cir. 1977).

\(^{83}\) US Courts consider “unsuitable” an investment if it is incompatible with the investor’s objectives and if
the broker recommended it, even though she knew or reasonably believed that the investment was
reasons to extend this duty to this high-risk credit market:

1. Conflict of interests between broker and lender (brokers are often on lenders’ payroll);

2. Cognitive biases that affect the borrower’s choice (the suitability requirement can lead lenders to assure an optimal framing of decisions);

3. Lender and broker’s opportunism as their actions rely on incentives based on volumes (due to securitisation). The subprime borrower, as examined above, is an unusual borrower who is not totally able to assess its risk profile and the suitability of its financial choice. The exercise of the freedom of choice is clearly affected by information asymmetries and cognitive biases.

The suitability test, then, is a way to internalize the harm and to support the public interest arguments, as defined above. It was originally taken from the anti-fraud rules and it implies that the provision of loans and advices should be related to the customer’s risk profile (Hazen 2006). This is an essential step to cure moral hazard, solve the problem of the incentive compatibility constraint, and promote responsible lending. Once defined guidelines for the suitability test, violations would be more easily proved and lenders will be pushed to comply with their obligations. This test may avoid unnecessary price regulation and its negative aspect of limiting the freedom of action of market forces (Silverman 2005).

Unclear definition of suitability may promote a decline in legitimate subprime lending and credit rationing. Suitability means to assure that the provided product is a “good product”, coming from a “good loan process”. Therefore, the suitability requirement should be based on guidelines and best practices (self-regulation, etc) checked by supervisory authorities with the same mechanisms already efficaciously working for banks. In securities regulation, a self-regulatory organisation (SRO) as the National Association of Securities Dealers (NASD), in 1939 firstly defined the suitability doctrine and still nowadays these SROs (NASD, NYSE, etc) provide a precious framework of rules to efficiently enact the suitability test (Poser 2001). The application of a suitability test is also implemented in Europe, thanks to the MiFID Directive.


The suitability rule was originally defined in USA as an antifraud device (violation of the Rule 10b-5 under section 10(b) SEC Act 1934, 17 C.F.R. § 240.10b-5, 2001). See Clark v. John Lamula Investors, Inc., 583 F.2d 594 (2d Cir. 1978). In EU, instead, the suitability rule was basically born as a rule to widely protect investors confidence and to foster market integrity; see MiFID/UCITS Conduct of Business Regime, Art. 19, n. 4 CE Directive 2004/39 and Art. 35-37 CE Directive 2006/73; Moloney (2002 and 2005).

However suitability may imply different meanings and should not be only based on credit scores. The suitability requirement implicitly assumes the use of standard, instead of specific rules (risk of regulatory arbitrage; Engel and McCoy 2002). The flexibility of standards permits tailoring requirements around the abuses they want to fight (and where frequently rules fail). Then, they allow clearer understanding of brokers and lenders’ recommendations (Sunstein 1995). The standard should be focused on the process and should not exclusively consider the product provided. The test should be mandated and designed around three aspects that should be taken into account in the assessment of the product suitability with the borrower’s risk profile:

1. Ability to repay (affordability);
2. Product designed in borrowers’ best interest, with the presence of net tangible benefits (appropriateness; after the borrower’s legal declaration of the aim of its purchase); and
3. Consumer’s understanding and absence of predatory practices.

The combination of these three aspects may give “suitability” to the transaction. If not suitable, instead, the financial firm should not sell the product or it should be held liable towards third parties in case the default or missed payments would affect the stability of the bank (EU COM 2009). This strict liability should only partially reward borrowers (e.g. modification of the loan, refinancing, etc), in order to avoid moving all the burden of the decision and responsibility on the other party.

Nevertheless, both parties have private information and the risk of over-litigation on what is “suitable” is always there (Putney 2003). A suitability requirement thus ought to be modelled as a “partial warranty”, as used in consumers’ regulation. This system in fact is efficient only when the two parties retain private information and they are reluctant to exchange it (Priest 1981 and Parisi 2004). Hence, the suitability coverage should be excluded when borrowers have “voluntarily and explicitly” retained information at the signing of the subprime mortgage contract, if the information was considered “sensible” to efficiently assess their risk profile and to provide a financial solution that would suitably fit with their characteristics (incentive to responsible borrowing). They would lose the benefits of a suitability test. Exchanging private information (suitability coverage in exchange of relevant information on risk) will increase protection from moral hazard. This protection comes from the possibility that subprime borrowers would prefer to lose the suitability coverage in order to get a lower interest rate, if they do not reveal relevant information. However, lenders are always

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87 As should be defined by the Federal Banking Agency (US Mortgage Reform, Title II, Sec. 202).
induced to follow the suitability requirements in the supply of credit for subprime borrowers, because they do not know if the other party reveals all the relevant private information (voluntarily or involuntarily). It is possible, finally, to indicate with the suitability requirements a set of events that may worsen borrower’s financial conditions, in order to support her if in trouble with the mortgage (as an example of best practice; e.g. serious health problems). The function of the “voluntary retention” of private information is important because it permits to exclude lenders’ malpractices and then the use of the opportunistic defence in relation to information in their view kept secret by borrowers. For instance, the transaction is unsuitable when lender gives money with much higher monthly payments after some years to a low-income borrower only on the basis of a variable income (seasonal salary), with non-stable job and no assets (unjustifiably relying on future proceeds as excuse, because the lender is perhaps going to sell the mortgage). As result of an optimistic bias, borrowers will tend to see their own salary increasing in future periods, but in reality there is a high risk of default, so the process of origination may not be suitable. The lender, however, could come out saying that the borrower kept secret information about her health problems that have determined the default. In this case, the borrower may have involuntarily missed to give information because she did not know of this problem or it was not clear the gravity when she signed the contract. Therefore, the lender should not escape her suitability judgment and the borrower would still get a help to modify the mortgage in a sustainable way, if it is not too late!

This solution is not a first-best because this partial warranty model does not prevent from kicking out of the market the extremely high-risk borrowers, who ask for a loan also if they have higher probability of default and keep secret some private information. Hence, the suitability requirements with good guidelines and best practices will only partially fill the gap in the risk assessment of subprime low-income borrowers. In addition, the irrational behaviour of the borrower - when she has to face two losses (risk seeking) - helps to reject the incentives given by the partial warranty model solution. In fact, the borrower would seek risk when she has to choose between mortgage rejection and mortgage retaining information. By contrast, the partial warranty model seems to give the right incentives to the majority of subprime borrowers who see a very good deal in the exchange of private information for suitability coverage.

An execution-only option (to opt out) for specific categories of borrowers (sophisticated) or financial products (low amounts) could be cost-efficient. For instance, sophisticated borrowers would explicitly choose a riskier mortgage and they would avoid suitability tests, relying on their own ability and investments in risk management. It is a rule already existing in the EC securities regulation, so called execution-only clause\(^{88}\).

In conclusion, critics are mainly focus on the uncertainty of this system of risk assessment (which increases subjectivity) and the related risks of credit rationing for the high costs of compliance (Duncan 2007). Competition can solve these problems but misleading incentives affecting the subprime lending structure call for correctives. The law should respect the positions of the various parties, based on the assumption that everyone will attempt to maximize own profits (Putney 2003). In effect, the utility maximization theory is the cornerstone of the capitalism from decades, but the lessons of the crisis show how this theory falls down when bounded rationality and rational ignorance move humans' behaviours. It is probably time to rethink some aspects of the capitalism, firstly moving from banking regulation.

5.1.3 Other responses: legal rules and retention mechanisms

There are other regulatory responses that the legislator should enact and others that could be not suitable in a Law and Economics perspective. Rules are particularly needed to forbid specific predatory practices that may affect the subprime market, namely, for example, “loan flipping” and “steering”.

First of all, as we described above, the cost of default are crucial to give the right incentives with moral hazard issues. As showed, these costs can be very low in the US market for subprime mortgages, not only for regulatory gaps but also for the of low-income borrowers behaviours (e.g. risk-seeking when facing two losses). We can compare default costs to default rules, slanted in favour of the less informed party that, in a post-contractual phase, is the lender. In general, default rules should reduce transaction costs because they prevent the costs of contracting around the possibility of opportunistic behaviours by the other party (borrowers), so leading to inefficient results (Goetz and Scott 1985). Default rules actually would reduce the distorting framing effect that leads loss aversion, as described above (borrower’s choice to default; Choi and Pritchard 2003). In effect, if disclosure and suitability requirements work well in a pre-contractual environment, where the lender is the most informed party, costs of default should work as default rules in the post-contractual context, thereby avoiding borrowers’ opportunism. These rules are essential for the efficiency of the subprime market also because borrowers are less willing to contract around default rules for a status quo bias affecting their behaviour (Korobkin 1998; Jolls et al. in Sunstein 2000). Therefore, an approach that could be efficient in the subprime market may be the use of default rules as a tool to encourage parties with more information to reveal their type before the transaction and to fill the gap within incomplete contracts (Ayres and Gertner 1989). This situation should reduce the impact of the adverse selection and moral hazard, typical effects of penalty default rules (a separating effect due to reduced

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incentives to be opportunist). A too high level of default costs, conversely, would induce also non-opportunistic borrowers to avoid the credit transaction, especially in subprime market where the risk is already high for every borrower. Therefore, a mix of penalty default rules (slanted against borrowers; e.g. high costs of default and partial warranty model) and regulatory requirements (e.g. disclosure and suitability requirements) may efficiently address major issues in the subprime market for residential mortgages.

A complementary tool to the suitability test, analyzed above, is the assignee liability that may hold the buyer of the mortgage liable on the secondary market for legal violations made in the origination of the loan (Peterson 2007). It is efficient only when the most directly involved parties (originators) are already charged with duties helping the accountability of the transaction (as a suitability rule)\textsuperscript{90}. This liability indirectly increases the scrutiny by loans’ packagers of the pure activity of origination, as professional party able to execute a first screening on the product before being securitised. This tool may also help to reduce churning and predatory practices by originators, which are going to push on volumes if they do not have “skin in the game” after selling them. Indirect involvement in the origination of loans will also give better incentives for loans’ packagers, which will buy loans after a scrupulous scrutiny of the assets quality. In addition, filtering out from the loans pool predatory loans is not extremely loved by financial markets (Engel and McCoy 2007) because it is costly and it reduces the volume of transactions and related profitability. It may also reduce the amount of resources in the credit market but the benefits of a better screening on mortgages origination should be not disregarded. Finally, it is clearly a borrower protection measure (Ernst 2008) and it would be hard to enforce it, namely to define when investors did all in their ability to recognize and to remove predatory mortgages. For these reasons, this legal protection should be carefully used and does not represent a very efficient solution.

Furthermore, a fee based on loan performance (using broker’s historical data or average in the market) and proportionate to the riskiness of the transaction could be an efficient tool to provide right incentives to help convergence of participants’ objectives. In particular, brokers may currently get from lenders a fee linked to the generated volumes of high-cost loans, favouring the use of steering practices (e.g. Yield Spread Premium). Therefore, the tool just mentioned may be a powerful incentive for brokers to care about the quality of the product proposed to the borrower and to make a first screening on consumers’ ability to repay and suitability, in general. There should be a deeper analysis to reconsider performance fees from lenders, who often are victims of the originated loans. The cost of a performance fees in term of enforcement are really low. The only risk may be brokers unjustifiably limiting access to the market for specific borrowers. However, also in this case, well-defined rules (limiting brokers’ liability) can

\textsuperscript{90} It is a rule already present in the narrow segment of the credit market (HOEPA loans) with a stricter discipline; see note 1.
permit brokers to give access to the subprime credit market also to those low-income borrowers.

Nevertheless, the securitization process moves the risk of bad performance on final investors; a better redistribution of the risk along the financial structure would improve the risk-based assessment and thus the quality of the financial products. Mechanisms of retention of loans or securitised products respectively by originators and issuers may redress economic incentives in a better way\textsuperscript{91}. However, it is crucial the choice of a percentage of retained products that does not discourage financial institutions to provide markets with these important tools. Splitting the stake in different tranches of risk may help to make the retention more attractive and effective. Finally, we may consider using a flexible percentage that moves in a certain range and then allowing participants to disclose it to the public. The disclosure of the retention percentage may trigger reputational mechanisms that may finally help to redress incentives in the best way.

In conclusion, a licensing system to keep under control the quality of the provision of high-risk products may only become a barrier to market entry. It is a tough solution for a function that competition between players on the specific terms may perform better. The subprime market can achieve an efficient and competitive market without this mechanism. The classical justification for a strict licensing system is the information asymmetries and the elimination of adverse selection fixing not the price but the quality of the product. A quality-fixing mechanism, as for price-fixing mechanisms, is not a preferable solution if the market competition may do it in a better way. Moreover, this solution is also more costly for consumers who have to face already a very expensive market.

\textbf{5.1.3.1 Interest rate ceilings: a “pro-usury” law}

Usury laws including interest rate ceilings - frequently used in past years - are a tough and old-fashioned solution to remove predatory lending. This is a form of price regulation currently enacted by few States between the most advanced ones. Mainly used in the regulation of telecommunications and energy markets, a price cap gives powerful incentives to reduce firm costs and to fix a second-best price\textsuperscript{92} below a certain level. In the banking industry this price-risk cap (with price floor effects) is an easy way

\textsuperscript{91} A mechanism of loans retention (to 5\% and only non-qualified loans) by originators have already been considered by the US regulator in the new mortgage reform; see US Mortgage Reform, Title II, Sec. 213. Instead, a mechanism of retention by the issuer of securitised products is under discussion in the Basel Committee and the proposed retention percentage is also the 5\%. See, in general, on retention mechanisms in securitisation, Fender and Mitchell (2009).

to apparently fight usury, but what about costs? It determines two main consequences: credit rationing and unsatisfied demand (product substitution). The credit rationing limits the access to the credit market for high-risk debtors\textsuperscript{93}, precluding, as for the Italian credit market case\textsuperscript{94}, the presence of an efficient and developed market for high-risk borrowers (e.g. a subprime market). It leaves out of the market the higher-risk debtors who are rationally induced, especially in case of primary necessities, to access the usury market. Instead, the existence of a legal market for high-risk borrowers, as the subprime market, permits a real contrast to the usury because it proposes to these people a valid, cheaper and safe alternative. Only competition on interest rates and more flexibility, in a context of legal certainty of the property rights, can beat the usury indeed\textsuperscript{95}.

Furthermore, there is another effect that it may be defined as a “behavioural effect” (as irrational aspect) and affecting high-risk borrowers. In the presence of an interest rate ceiling high-risk borrowers face two losses: the impossibility to receive credit from the legal market and to satisfy their needs (frequently primary needs, as the first home purchase); and the losses coming from the risk of accessing an illegal market where they may suffer unsustainable interest rates and violent mechanisms of enforcement. This choice brings borrowers to move on the riskier solution to absolve to their needs (the usury market). Therefore, the price sensitivity to interest rates changes (Stiglitz and Weiss 1981) and the “risk-seeking effect” fosters illegal usury markets. In addition, the use of ceilings may induce those borrowers to substitute high-cost mortgages with alternative loans because the basis on which to calculate the interest rate ceilings is typically higher (credit cards, personal loans, etc). In Italy, in particular, the difference in the interest rate ceilings between different types of credit instruments brought high-risk borrowers to make massive use of alternative tools, mainly offered by players different from banks\textsuperscript{96}. The final outcome thus may also hamper financial stability. Usury laws so are easy to circumvent in the modern economy; it would be a more powerful incentive increasing default costs to inhibit bad behaviours as alternative solution (Hynes and Posner 2001). As conclusion, regulators should not forbid lending to high-risk borrowers but they should work more to impede improper behaviours and


\textsuperscript{94} See Giovanni Carosio, “Prevenzione dell’usura ed evoluzione dei mercati creditizi” (Usury Preemption and Evolution of Credit Markets), speech at the 2\textsuperscript{nd} Justice Commission, Italian Senate, Rome, 27 March 2007.


\textsuperscript{96} From the approval of the law n. 108 of 1996 (putting an interest rate ceiling), the role of the alternative sources substantially increased to cover today a relevant role in the Italian credit market, see Bank of Italy, Annual Report 2007, May 31\textsuperscript{st}, 2008, \url{http://www.bancaditalia.it/pubblicazioni/relann/rel07;internal&action=_setlanguage.action?LANGUAGE=en}.
malpractices that artificially increase the risk in the market, over a sustainable level (interest rates, as prices, are not the problem!). The artificial alteration of the efficient functioning of credit markets (higher risk), as for cartels in competition law, should push legislators to impede these behaviours that artificially shape the market and do not regulate prices. Regulating prices would definitively hamper competition, especially in a market that structurally has oligopolistic characteristics, as few players, heterogeneous and customized products and, especially for high-risky markets, reduced borrowers’ sensitivity to interest rates. Removing the access to wealth accumulation tools for low-income people may have large negative externalities. Consequently, from a public interest view, interest rate ceilings forbid the access to a segment of the population, compromising a relevant tool for total wealth accumulation and increasing the social losses related to the use of illegal or alternative and costly lending sources.

5.2 Reputational mechanisms and supervision

Reputational mechanisms and stronger supervision are other two relevant tools to promote an efficient market for subprime mortgages, through solving moral hazard and adverse selection problems.

Firstly, the presence of players with reputational concerns consequently reduces the probability of bad practices. Representative subprime lenders are usually small State-chartered financial companies that do not have any reputational capital in the subprime market. Subprime borrowers are usually disconnected from traditional credit markets and experience greater risk of default. Banks are reluctant to originate subprime loans because their involvement in a riskier market would be particularly negative for their reputation in the credit industry and it may affect parts of their business built on reputational capital (e.g. investment services, etc). Therefore, the “dirty” job made by those small companies is mainly due to the refusal for reputational concerns by big banks. Moreover, the reputational problems of banks may create a prisoner’s dilemma. For instance, it is hard to find a bank making the “first move” to entry a particularly poor neighbourhood where borrowers would be mainly high-risk. Conversely, the presence of reputational concerns for banks does not mean that subprime lenders should not have reputational capital at all in that market. Developing reputational capital in high-risk markets is a mechanism to reduce strong incentives to pursue malpractices (due to the large stake on the table), moral hazard and adverse selection problems. As mentioned above, flexible mechanisms of retention with disclosure of retained percentages may create the need for reputational capital, as long as the mechanisms are efficiently designed. Then, it is also important to foster self-regulation mechanisms and best practices that may help consumers to choose between many lenders (e.g. the obligation to have an ethical code). This situation may support also the development of a market suitability test. Stimulation of comparability and the ability to shop around increases competition and its positive aspects. Finally, the role of the education can be useful to increase knowledge of financial terms offered by subprime
lenders and obviously to understand the risk of choosing lenders without any reputational capital (codes, best practices, etc). Community Based Organizations (CBOs), in the US, perform a great function in services and advices to improve borrowers’ financial education and their presence should be promoted even more especially in poor communities\textsuperscript{97}.

Secondly, if banks and their subsidiaries have strong supervision on normal banking activities, the large category of subprime lenders (around 60\% of all lenders; Gramlich 2007b) is largely gone unsupervised. Non-depository State-chartered institutions play a pivotal role in the subprime mortgages market but they are only supervised by State financial agencies (no Federal supervision at all, neither from the Federal Reserve). With its important role, supervision may detect lenders’ malpractices and reduce the artificial risk in this credit market, preserving market integrity. It may also act to control the evolution of market conditions, assuring an efficient and smooth functioning of market mechanisms. In addition, non-depository institutions do not face stringent capital requirements or license laws. This situation does not imply that private financial institutions should be supervised like large depository institutions, as banks are, but a minimum role by third-party supervision is essential to improve the monitoring of moral hazard and to shield the system from systemic risks. In addition, supervision may help enforcing guidelines and best practices to support an efficient implementation of the suitability test. A stronger supervision would have also a moral suasion effect, further reducing the risk of lenders’ malpractices.

Finally, information sharing between lenders and supervisors may improve the quality of risk assessment and supervision. Exchanging information about borrowers’ risk in fact may reduce moral hazard and adverse selection as widely discussed.

### 6. Conclusions

This paper tries to make a deep analysis of the subprime market and its failures with the use of some tools used by the behavioural Law and Economics in different fields, from competition law to financial regulation. The aim was to subjugate the interdisciplinary method to the research of straightforward policy responses to the failures in the subprime market. Therefore, the work has been split in four parts. The first part has described how the subprime market is structured, focusing on how the market works and how the financial structure absolves to the function to spread the risk in the market in order to get new resources to expand the availability of credit. We analysed the structure of the market and relevant characteristics of the typical subprime mortgage and its market. Secondly, the analysis touches upon borrowers’ behaviours and how rational and irrational aspects shape them. The behavioural Law

\textsuperscript{97} See Apgar, William C., “Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations”, \textit{Joint Center} Harvard University, Cambridge, 2004.
and Economics gives astute insights on human behaviour in order to understand how to tackle relevant issues, not clearly understood in the classic field of Law and Economics. Thirdly, we have carefully described the incentive structure that affects brokers and lenders and then their customers. This financial structure promotes highly distortive incentives. The informational gap between parties then feeds moral hazard and adverse selection problems. In the last section of the paper, we put together the whole analysis made in the first three parts in order to address policy responses and explain their economic and legal justifications. We measure these responses on their ability to give the right incentives to reduce moral hazard and adverse selection, which are dominant problems. We model the responses in four areas:

1. Mandatory disclosure requirements and simplification;
2. Suitability test and "optional warranty";
3. Assignee liability or retention mechanisms; and
4. Reputational mechanisms and stronger supervision.

We concluded that an efficient solution could be the mixed action of: stricter and wider mandatory disclosure (with separated disclosure of servicing fees), suitability test with optional features, retention mechanisms with flexible percentages (disclosed), stronger supervision for subprime originators and promotion of self-regulated actions (e.g. code of ethics). This framework of interventions is based on a joint system of public (e.g. settlements or fines) and private enforcement solutions as, for instance, the proposed solutions for responsible lending and borrowing in the suitability test. Without an efficient enforcement system, the management of a risky market as the one for subprime mortgages can be out of control. We may conclude that the absence of regulation and supervision, and the presence of cognitive biases and misleading incentives have shaped the US subprime mortgages market and caused these failures along the chain, from the origination process to the sale of securitised products.

The analogy of subprime mortgages with experience and credence goods implies a distinct approach from the classical literature on credit markets. The aim of this paper is

98 As showed above, for example, public enforcement tools like social norms or considerations of fairness are not so effective in the subprime market, as they are respectively affected by loss aversion and lessening in "credit morality", plus other cognitive biases as the self-serving one.

99 The public enforcement is extremely expensive but if it is particularly effective, like in US, it "could be run by public-regarding policymakers and can invoke sharp, criminal, financial and reputational penalties that deter egregious wrongdoing", see Howell E. Jackson & Mark J. Roe, "Public and Private Enforcement of Securities Laws: Resource-Based Evidence", June 3, 2008, www.ssrn.com; in addition, the effectiveness of the enforcement is quite different between States and, with the wide diffusion of the class action, the US experience correctly mixes public and private enforcement, solid characteristic of common law countries, see John C. Coffee, Jr, " Law and the Market: The Impact of Enforcement", Center for Law and Economics Studies, Columbia University School of Law, WP No. 304, April 4, 2007.
to shed new lights on credit markets and to propose responses to their failures. The policy and regulatory responses promote competition and reduce participants’ opportunism stimulated by the complex nature of the offered products. The securities regulation has given precious tools to thwart opportunistic behaviours and to improve the risk management. The final conclusion thus is not to ban the subprime market. Its idiosyncratic characteristics need, however, to be addressed with specific responses that may finally create an efficient structure of incentives. The whole financial system should learn from the lessons drawn by the recent financial crisis and understand how can be challenging the sophistication of modern financial markets. Regulators across world should work to design interventions more focussed on incentives and behaviours and less on products and market structure as such – more easily subject to be legally and strategically circumvented - if they do not want to experience another collapse like the one is shaking this intricate global economy.


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Legal and economic approach to tying and other potentially unfair and anticompetitive commercial practices: focus on financial services

Diego Valiante  
June 2009

Abstract

This paper analyses the economic and legal aspects related to widespread practices as tying, bundling and other potentially unfair commercial practices in the financial services industry, with special focus on the European financial services market (without omitting the latest developments in the US market and case law). Therefore, the approach of law and economics that we hold in the text aims at illustrating the rationales for applying both antitrust and consumer protection legislation to the practices subject to analysis in this paper and observed in the retail financial services market. Section 1 below explores the main findings of the legal and economic theory as regards the applicability of antitrust rules to the practices at hand. This section also discusses the possibility to treat new commercial practices under antitrust law. Section 2 illustrates the economics of tying, bundling and other unfair commercial practices from a consumer policy perspective, and reports empirical data on switching costs and patterns of consumer behaviour in retail financial services and in other sectors of the economy. We highlight sources of specific situations and cognitive biases that may be cause of irrational behaviours in judgement and decision-making processes of a retail consumer. Section 3 proposes a new multi-stage test for the assessment of these practices under competition and consumer policy. We then conclude that the provision of retail financial services should balance tools of antitrust and retail consumer policy, as the impact of anticompetitive and/or unfair practices may harm customers' mobility, choice and welfare, thereby thwarting in particular the fragile integration of the European internal market.
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# TABLE OF CONTENTS

**Introduction**  
1. The competition policy dimension of tying and other potentially unfair commercial practices  
   1.1 Cross-selling strategies  
   1.1.1 The antitrust law and economics of tying and bundling  
       1.1.1.1 The leverage theory and the Chicago School criticism  
       1.1.1.2 Anti-competitive effects and the revival of the leverage theory  
       1.1.1.3 Post-Chicago theories and other efficiency-enhancing features of tying and bundling practices  
   1.1.2 Tying and bundling under EC competition law  
   1.1.3 US approach to tying and other potentially unfair commercial practices  
       1.1.3.1 Tying and similar practices in US antitrust law  
       1.1.3.2 The US ban on tying in the banking sector: few cases and systematic circumvention  
   1.1.4 Preferential or exclusive agreements  
   1.2 Other potentially unfair commercial practices as exclusionary abuses in competition law  
       1.2.1 Conditional sales practices  
       1.2.1.1 Conditions attached as essential for the conclusion of the contract  
       1.2.1.2 Conditional rebates as an antitrust infringement  
       1.2.1.3 Loyalty rebates  
   1.2.2 Aggressive commercial practices in competition law  
2. Tackling tying and other potentially unfair commercial practices in consumer policy  
   2.1 The rationale for protecting consumers and SMEs against unfair commercial practices
2.1.1 Informational asymmetry between providers and customers

2.1.1.1 Financial education and customer effort in “shopping around”

2.1.1.2 Information asymmetry, relationship banking and switching costs

2.1.2 Behavioural economics and decision-making biases

2.2 A closer look into switching costs

2.3 Potentially unfair commercial practices in the retail financial services sector

2.3.1 Cross-selling practices

2.3.1.1 Tying and pure bundling

2.3.1.2 Mixed bundling and multi-product rebates

2.3.1.3 Preferential or exclusive agreements

2.3.2 Conditional sale practices

2.3.2.1 Action-conditioned practices

2.3.2.2 Behaviour-conditioned practices

2.3.3 Aggressive commercial strategies

2.3.3.1 Unsolicited Offers

2.3.3.2 Churning

2.3.3.3 Steering

3 Measuring the impact of tying and other potentially unfair practices in the retail financial services sector: a multi-stage test

Conclusions
Introduction

Tying, bundling and other potentially unfair commercial practices in the retail financial services sector have been subject to attention in the economic theory, especially as far as competition policy is concerned (less for consumer policy). The findings of the economic literature have been also translated into legal rules, especially as far as antitrust law is concerned. Accordingly, in many countries around the world tying and an array of other cross-selling practices – including conditional rebates, exclusivity agreements, etc. – are considered to be potentially distorting competition and leading to anti-competitive foreclosure. This is reflected in the current policy of the European Commission on exclusionary abuses, as highlighted in the recent Guidance paper adopted on December 2008.

Against this background, the analysis of the effects of tying and other potentially unfair commercial practices from the standpoint of consumer policy is substantially more fragmented and sparse in the literature. This is probably due to the fact that tying is universally considered to be a ubiquitous practice, and that only under certain circumstances can be considered as detrimental to customers – the fact that the tying firm is dominant on its relevant market for the tying product is indeed one of these circumstances. Since the 1960s, increased attention to consumer protection in contractual relations with firms has led to a better understanding of the behavioural and informational issues that emerge in these particular types of contracts. Specific legislation on standard form contracts (such as the Loi Scrivener adopted in 1978 in France, the Gesetz über Allgemeine Geschäftsbedingungen AGBG passed in 1976 in Germany, but also the Supreme Court decisions in Henningsen v. Bloomfield Motors and Williams v. Walker-Thomas Furniture, Inc. in the US) has marked the first step towards consumer protection in several countries, and culminated at EU level with the approval of Directive 93/13 on 5 April 1993 on unfair terms in consumer contracts. Subsequently, issues that had been postponed during the debate on Directive 93/13 – such as, i.a. the sale of goods and associated guarantees – were addressed by other EU

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100 See e.g. Willett, C., Fairness in Consumer Contracts. The case of Unfair Terms, Ashgate Publishing, 2007. On US cases, see Williams v. Walker Thomas Furniture, 350 F.2d 445 (D.C. Cir. 1965); and Henningsen v. Bloomfield Motor Inc., 161 A.2d 69 (N.J. 1960). In Henningsen, 22 the buyers of a car sued a carmaker for the consequential damages from an accident caused by a defective steering mechanism. The carmaker defended on the ground that the buyers waived any right to sue for consequential damages in fine print, but the court ruled in favor of the buyers, holding the waiver ineffective on the basis of “[t]he gross inequality of bargaining position”. In Williams, the plaintiff had bought several pieces of household furniture from Walker-Thomas for about $1300 and had paid all but $164 of this amount; she then bought a stereo from Walker-Thomas for $514. The contract she signed included a cross-collateralization clause that gave Walker-Thomas a security interest in both the stereo and all the other furniture she bought from it over the years. The clause was held unconscionable by the Supreme Court – a finding that led to a shift from the “duty to read” rule in place since the 1860 judgment of the Court of Exchequer in Lewis v. Great Western Railways. See Todd D. Rakoff, Contracts of Adhesion: An Essay in Reconstruction, 96 Harv. L. Rev. 1174 (1983). And Baird, D., The Boilerplate Puzzle, Michigan L. Rev Vol. 104, 933, March 2006.
Directives\textsuperscript{101}. More recently, also due to developments in the law and economics literature in this field, the attention of regulators has also focused on the pre-contractual phase of consumer contracts, \textit{i.e.} to the moment in which consumers make up their mind on their willingness to purchase and accept the contractual conditions. In this phase, consumers are often dependent on the information that is provided by their counterpart, and for this reason legal rules must be devised to ensure that the communication of information is not misleading or affected by cognitive biases. Accordingly, unfair commercial practices have been tackled by legislators in several EU countries, especially with the Unfair Commercial Practices Directive.

In this paper we explore the rationales for applying both antitrust and consumer protection legislation to the practices subject to analysis in this paper, \textit{i.e.} tying and other potentially unfair commercial practices observed in the retail financial services sector. Section 1 below illustrates the main findings of the legal and economic theory as regards the applicability of antitrust rules to the practices at hand. Section 2 illustrates the economics of tying, bundling and other unfair commercial practices from a consumer policy perspective, and reports empirical data on switching costs and patterns of consumer behaviour in retail financial services and in other sectors of the economy. Section 3 proposes a test for the assessment of these practices under the umbrella of competition and consumer policy. We then draw conclusions on the potential impact of the practices under scrutiny on consumer welfare.

1. The competition policy dimension of tying and other potentially unfair commercial practices

This section deals with tying and other potentially unfair commercial practices as defined in the economic theory and in the EU and US case law. The following paragraphs give an overview of the historical evolution of the different legal and economic approaches in the law and economics literature, focusing on benefits and costs of these practices under the competition policy view. The final part identifies four categories of potentially unfair commercial practices looking at the EU legislation and the common practices adopted in the retail financial services sector. We will analyse how to deal with these practices under competition law.

\textsuperscript{101} See \url{http://ec.europa.eu/consumers/rights/gen_rights_en.htm}.
1.1 Cross-selling strategies

1.1.1 The antitrust law and economics of tying and bundling

Tying is a ubiquitous business practice, which occurs when two or more products are sold together in a package and at least one of these products is not sold separately. In this case, the consumer can buy the tied product alone, but not the tying product without the tied one. This implies that customers that would not buy all the tied goods may be forced to purchase extra products that they did not want (see figure 2 below).

Tying is usually distinguished from another similarly widespread cross-selling strategy, named pure bundling. Pure bundling occurs when none of the package components is available separately, and the components are offered in fixed proportions. Pure bundling is in fact the simultaneous sale of two or more products only as bundle, not individually. The main difference concerns the proportions requirement. Pure bundling implies fixed proportions, while tying involves variable proportions and – most often – two distinct sales (figure 2). The incentives to bundle are higher when the number of items produced by a firm is high enough to achieve high costs savings (distribution, etc) and better price coordination (i.e., internalization of complements cross-price effects) through the bundle.

If products are also sold on a stand-alone basis, the practice is defined as “mixed bundling”; in this case the bundle is usually sold at a discounted price (multi-product rebate) compared to the sum of the prices for the bundled goods when purchased separately.

From a competition policy perspective, several different variants of tying practices have been considered. For example, the purchase of a product with the requirement to buy consumables linked to that product from the same seller. Another typical example of tying is the cross-selling practice to tie the purchase of a “blockbuster” movie to the purchase of a less famous one (i.e. block booking). In this case, although consumers


105. In this text, it will be used indifferently the word tying to define every kind of packaged sale that is not bundling or mixed bundling, as described above.

106. See Motta (2004), cit.

can buy variable proportions of the tied product itself, they must buy the tying product with the tied movie (at least one copy). The variability of the quantity proportions is “complete” for the tied product (consumer can decide to take two or more copies of the tied product and one or none of the tying movie) and “fixed” for the tying product (one to one). Other examples are usually related to durable goods, which need consumables from the same supplier and so on.

On the contrary, a newspaper is a pure bundled product because consumers access different kinds of topic-specific news sold together, without any possibility to buy just the “sports” section or to decide how much “sport” they want in that specific newspaper (fixed proportions). There is a clear economical and practical justification to this solution, since selling a newspaper in different sections would generally be more costly for distributors and consumers. However, in other cases these justifications may be less clear, so raising legitimate objections on the impact of the practice on consumers and competition in general. Other bundled products are cars, radio, shoes and so on.

**Figure 16 – Bundling, Tying and Separate Component Selling**

Tying and bundling are widespread phenomena that permeate every single aspect of consumers’ daily life. From retail banking products (e.g. the common operation to tie the provision of a loan to the concurrent opening of a current account) to consumer goods (e.g. hotel room and breakfast, personal computers and operating systems, etc.), it is possible to list a huge number of cases. Moreover, a typical case of tying (contractual and technological) may likely come up in the so-called aftermarket or in the market for consumables where simple reasons of technological efficiency or exclusionary behaviours (or both) can increase the number of tie-in sales\(^{108}\). Cross-selling strategies in the retail financial services sector occur mainly through tying strategies (number 5 and 6 in Table 1), by offering only the bundle (n. 4), or offering the bundle at a discounted price (n. 7)\(^{109}\).

### Table 1 – Possible product combinations

<table>
<thead>
<tr>
<th>Possible product combinations</th>
<th>X</th>
<th>Y</th>
<th>XY</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Components Selling</td>
<td>X</td>
<td>Y</td>
<td>-</td>
</tr>
<tr>
<td>2. Component Selling</td>
<td></td>
<td>X</td>
<td></td>
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<tr>
<td>3. Component Selling</td>
<td></td>
<td>Y</td>
<td></td>
</tr>
<tr>
<td>4. Pure Bundling</td>
<td></td>
<td></td>
<td>XY</td>
</tr>
<tr>
<td>5. Tying (X to Y)</td>
<td>X</td>
<td></td>
<td>XY</td>
</tr>
<tr>
<td>6. Tying (Y to X)</td>
<td></td>
<td>Y</td>
<td>XY</td>
</tr>
<tr>
<td>7. Mixed Bundling</td>
<td>X</td>
<td>Y</td>
<td>XY</td>
</tr>
</tbody>
</table>

Source: author’s elaboration based on Evans (2006).

In terms of antitrust scrutiny, the insights of economic literature and the latest developments in the US case law have shown a tendency to move from a formalistic approach to tying – the so-called *per se* rule approach – to a “rule of reason” approach, in which proof of the likely anti-competitive effect is required, and efficiencies created by the conduct may redeem it under antitrust rules\(^{110}\). As will be shown in the next

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\(^{110}\) In the US, the first move away from the *per se* rule was done by the Supreme Court decision in *Jefferson Parish Hospital Dist. N. 2 et al. v. Hyde*, 466 U.S. 2, 16 (1984). Later, in the *Microsoft III* decision, the US Court of Appeals introduced a rule of reason approach, limited to “platform innovation for PCs, network computers and information appliances”, see *id*. 

80
paragraphs, the likelihood that a tying practice leads to anti-competitive foreclosure depends on a number of factors, including the structural features of the market and the characteristics of the product (e.g. fixed and marginal costs).

1.1.1.1 The leverage theory and the Chicago School criticism

Tying has been largely and heatedly debated during the last century and in recent years. The dispute between scholars on the likely anti-competitive and pro-competitive effects of this practice dates back to the beginning of the 20th century with the recognition by the US Courts of the “leverage theory”\textsuperscript{111}. The leverage theory states that

\begin{quote}
\textit{“[t]ying provides a mechanism whereby a firm with monopoly power in one market can use the leverage provided by this power to foreclose sales in, and thereby monopolize, a second market”}\textsuperscript{112}.
\end{quote}

Therefore, tying may be an exclusionary conduct that forecloses the tied market (through the tying market) to new potential competitors. This theory holds in many cases even though the criticisms coming from the Chicago School have strongly weakened it\textsuperscript{113}. Indeed, it is unquestionable that, under specific assumptions, the leverage theory may not hold. In particular, Chicago scholars have argued that tying cannot increase the monopolist’s profits if the tied market is competitive (the so-called “single monopoly profit theorem”), as this would eventually reduce the monopolist’s aggregate sales\textsuperscript{114}. The underlying assumptions are however very strong:

- There must be perfect competition in the tied-market (no barriers to entry, price-taker firms, etc.)\textsuperscript{115};

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\textsuperscript{114} For an explanation, see Motta M. (2004), \textit{cit}.

\textsuperscript{115} A market is purely or perfectly competitive if each firm assumes that the market price is independent of its own level of output. The model of perfect competition is based on three
• The tied products are sold in fixed proportions (as a bundle);
• The tied products are complementary, not substitutes.

Under these conditions, Chicago scholars observed that there would be no incentive for the monopolist to engage in tie-in practices, since it can extract only one monopolistic profit. Therefore, it is more plausible to justify tied sales with a desire for price discrimination (increasing total surplus\textsuperscript{116}) and/or a search for other efficiencies. In fact, Nobel Laureate George Stigler was the first to show that this conduct can reduce the variance between consumers’ reservation prices, allowing price discrimination with a larger extraction of the consumer's surplus and a reduced deadweight loss\textsuperscript{117}. The practice is particularly advantageous for the firm if the consumers’ valuation of the products is inversely related.

Moreover, other Chicago scholars supported the single monopoly profit through their further formalizations around tie-in strategies. In a very famous article, Adams and Yellen (1976) showed that, with two separate products and a heterogeneous and independent demand, a mixed bundling solution seems to be optimal to increase the total surplus available\textsuperscript{118}. The classic example is that of two consumers, Adam and Bob,

\textsuperscript{116} See Bowman W.S. (1957), \textit{cit}; Burstein Meyer L., “The Economics of Tie-in Sales”, \textit{Review of Economics and Statistics}, February 1960, 42, pp. 68-73. Surplus represents a measure of welfare for consumers or firms in a specific transaction or market outcome; it is calculated as the area beneath the inverse demand curve, delimited by the price and such demand curve. The total surplus refers to consumers and suppliers’ surpluses: the total surplus increases because the supplier can perfectly price discriminate, through specific tying solutions, between single consumers (increasing his own surplus and reducing the consumers’ one). If the supplier fixes a price there will be part of the demand that does not want the product at those conditions: by price discriminating, the supplier will also serve that part of the demand but the consumer’s surplus will be reduced in favour of the supplier, who will catch more surplus than the surplus lost by the consumers (people out of the market will now be served). Therefore, even though this transfer of surplus is questionable in a consumer’s view, a mechanism of perfect price discrimination increases the total surplus and should be considered Kaldor-Hicks efficient, even though it involves distributional concerns. However, there is no unanimity on the increasing effect of the total surplus through perfect price discrimination, see for example Motta (2004), \textit{cit}.

\textsuperscript{117} Stigler George J. (1963), \textit{cit}.

with different willingness-to-pay (wtp). Adam has a modest wtp for both products, while Bob has a high wtp just for one of the two products. In this case, mixed bundling is the only strategy that allows catching both consumers. In effect, the first consumer (modest wtp for the two products) will choose the bundle, while the second one (high wtp for one of the two products) will only choose one product.

In 1982, Richard Schmalensee extended the model to a monopolist in the tying market facing perfect competition in the adjacent tied market and independent demand for the two products (this time with a Gaussian demand, that is a joint normal distribution of reservation values), with non-negatively correlated valuations for separate components. He argued that, under these conditions, mixed bundling is an optimal strategy when the wtp for the two products in the monopoly tying market and the competitive tied market are negatively correlated. The price of the bundle should be lower than the sum of the price of the single components. In effect, this strategy reduces variation in customers’ reservation prices and generally increases total welfare. An important corollary of this finding is however that suppliers will be able to capture a significant portion of consumer welfare: in a nutshell, also in Schmalensee’s analysis bundling practices lead to expanded access to the market for consumers, and to an extraction of consumer surplus by the supplier – in economic terms, total welfare increases, but consumer welfare decreases compared to a situation of pure unbundled sales. This situation involves distributional concerns but, for an economic point of view, it may be considered efficient.

Even though the underlying assumptions are quite extreme, these theories have been largely sustained by Chicago school advocates and implemented until new scholars and Post-Chicago economists pointed out the weaknesses of this theory and the possibility, under certain conditions, that anti-competitive effects materialise.

1.1.1.2 Anti-competitive effects and the revival of the leverage theory

Looking at the developments in the law and economics theory of tying in the past two decades, a broad consensus seems to have emerged on the possibility that, under specific assumptions, this otherwise common practice proves harmful for competition and consumer welfare. In a 1990 paper appeared in the American Economic Review,


120 It can be considered as “Kaldor-Hicks efficient” or “potentially Pareto-efficient”, since the practice produces a net benefit to society, despite the fact that one group (consumers) is left worse-off.

Michael Whinston pointed out the potential flaws of the Chicago School’s “single monopoly profit” theorem\(^\text{122}\). In his revival of the leverage theory, the author correctly argued that the theorem fails to explain situations in which the proportions between products are variable (as in tying arrangements). Then, the strong assumptions of monopolistic setting in the tying market and perfect competition in the tied market further lessened the power of this general proposition. In particular, Whinston focused on the role of tying as a strategy to deter entry by new players by showing commitment to tie the sales of product should entry occur\(^\text{123}\).

According to Whinston, the single monopoly profit theorem holds only when\(^\text{124}\):

- The tied market is perfectly competitive;
- The tied products are complementary (not substitutes); and
- The tied products are consumed in fixed proportions.

When one or more of these conditions do not hold, tying can still be seen as a strategy to leverage the firm’s own market power in the tying market into another (tied) market. This occurs in particular when:

- The tied product is consumed in variable proportions; or
- The market exhibits economies of scale or network externalities.

The latter situation can imply high entry barriers since competitors may not be able to reach a minimum efficient scale – or, in the case of network effects, the critical mass that makes sale of the good viable – that is reached by the monopolist through its tying practice\(^\text{125}\).

More recently, in a series of papers commissioned by the UK Office of Fair Trading,

\(^{122}\) Whinston M. D. (1990), *id.*

\(^{123}\) More in detail, Whinston illustrates a two-period model to show that the mere pre-commitment to bundle complementary products (tied product with variable proportions) at period 1 can result in less earnings in period 2 for potential entrants in the relevant markets. The bundle (or tie) thus becomes a tool to deter market entry. However, this threat may not be credible if the potential entrants know the final outcome. In turn, the monopolist will not choose to bundle if it would not successfully deter the entry: in fact, bundling may be an optimal strategy from an *ex-ante* perspective, but it is clearly sub-optimal when the firm decides to enter. It is thus a constraint to more aggressive behaviours in the period 2.

\(^{124}\) Note that Whinston (1990) does not distinguish between tying and bundling. However, these assumptions are consistent with our previous definition of tying: as a matter of fact, in tying arrangements the tied product usually is in fixed proportion (you have to buy at least one tied product, while you can buy variable proportions of the tying product).

Barry Nalebuff (2004) argued that, under specific assumptions, it is possible to deter entry also without commitment, if rivals can enter only one of the two markets\textsuperscript{126}. More in detail, Nalebuff showed that if the products are subject to independent demand by consumer, they are sold in variable proportions, and the demand for the tied product is inelastic\textsuperscript{127}, the incumbent may decide to charge customers less in the monopolistic market and to slightly increase the price in the tied market. In this way, the increased demand (marginally stronger in the monopolistic setting because already at supra-competitive price) will overcome the reduced income due to the discount. The same theoretical argument was then refined by other authors including Greenlee, Reitman e Sibley (2008), who apply the rationale to famous antitrust cases such as 3M Co v. LePage’s, SmithKline Corp v. Eli Lily & Co., and Ortho Diagnostics Systems v. Abbot Labs\textsuperscript{128}.

Nalebuff’s argument can be easily explained by means of two examples. First, let us assume that a firm A sells two goods, X and Y, and is dominant in the production of Y, while it faces actual or potential competition in X. Assume also that the two goods are not consumed in fixed proportions, and that the demand for the two products is independent (an increase in demand for one of the goods does not necessarily lead to an increase in demand for the other; and an increase in the price of one of the goods does not affect the demand for the other).

If this is the case, A will be able to set a price for Y ($P_Y$) in a way that maximises its profits, while the price for X ($P_X$) will be set by market forces and will thus equal the marginal cost of producing the good, $c$. Nalebuff shows that A can profitably engage in the following conduct:

- $A$ offers the bundle ($X+Y$) at a price equal to $P_Y + P_X = P_Y + c$
- $A$ then increases the price for $Y$ (unbundled) by a small amount $\delta$.

In this situation, consumers that need both products have to choose whether to buy Y at a higher price and X from a competitive supplier, or buy both products from A and get a discount from Y. This puts competitors in the X market at a disadvantage: they will not be able to replicate this offer by A. In addition, consumers that only need Y will be disadvantaged, as the price has increased to $P_Y + \delta$.

This type of strategy reduces consumer welfare, as consumers that buy the bundle are

\textsuperscript{126} Nalebuff B. (2004), \textit{cit}.

\textsuperscript{127} “Independent demand” means that the demand for the tying product is not related to the demand of the tied product; “inelastic demand” means that the demand is less reactive to a price increase, namely a producer can raise prices without heavily reducing the demand for its product.

not affected (the price remains the same), but consumers that buy only $Y$ will be disadvantaged. As stated by Greenlee, Reitman and Sibley (2008), a bundling strategy reduces social welfare if it leads to a monopoly price for $Y$ greater than would occur absent the strategy.

Assume, now, that $A$ decides to sell $X$ at a discounted price equal to $P_X - \epsilon$, under the condition that consumers buy also $Y$ at a higher price, say $P_Y + \delta$. For simplicity, assume that $\epsilon = \delta$. The price for the bundle will still be equal to the sum of the prices for the two products separately. However, the monopolist’s profits will increase alongside with total welfare.

What is more important, this strategy can deter the entry of new competitors. As a matter of fact, if a new entrant wanted to enter the $X$ market it would have to offer consumers at least the surplus value (if the following formula $< 0$):

$$\left(\delta * Q_{YNB}\right) + \left(- \epsilon * Q_{XNB}\right)$$

(If $> 0$ may be not convenient to buy the bundle instead of the products separately) to compensate for their loss if they decide not to purchase the $XY$ bundle altogether from $A$. This means that the new entrant $B$ should set a price that can be below cost. Since this type of bundling is not replicable by an as-efficient competitor, it does not pass muster under Nalebuff’s test and – despite increasing social welfare in the short run – should be considered as leading to anti-competitive foreclosure.

More generally, according to Nalebuff:

- When $X$ and $Y$ are consumed in fixed proportions, bundling can have an exclusionary nature whenever the incremental price of the $XY$ bundle compared to the price of $Y$ alone is lower than the Long-Run Average Incremental Cost (LRAIC) faced by $A$ for producing $X$.

- When $X$ and $Y$ are consumed in variable proportions, bundling can be anti-competitive if the price for $X$ minus the discount needed to retain $A$’s own customers is higher than the LRAIC faced by $A$ for producing $X$ (so-called “Ortho test”).

Nalebuff’s analysis has been very influential on competition authorities and courts in the past few years. The “leveraging” conduct described by Nalebuff deters entry even though there is no clear pre-commitment, and mitigates the inefficiency of monopoly pricing (making many consumers better off without harming anybody else, namely a

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129 Assuming that $\delta$, $\epsilon$, $Q$ and $P$ are natural positive values ($0 < \delta < P_Y$; $0 < \epsilon < P_X$) and that $\epsilon = \delta$, we can derive with some algebra this formula from $\left\{\left[P_X - (P_X - \epsilon)\right] * Q_{YNB}\right\} + \left\{\left[P_Y - (P_Y + \delta)\right] * Q_{XNB}\right\}$, which represents the original formula to calculate the surplus of the consumer if he decides to buy the bundle from $A$, instead of $Y$ from $A$ and $X$ from the new entrant $B$. $NB$ refers to the quantity in the “no-bundle” situation.
Pareto improvement\(^1\)). Of course, the foreclosure of competitors from the tied market \(X\) may lead to long-run inefficiencies due to lack of innovation, absence of product variety and choice for consumers, and ultimately even an increase in price, once \(A\) has obtained a large market share also in \(X\).

However, Nalebuff’s model was also subject to some criticism.

- First, the assumption of perfectly competitive \(X\) and monopolistic \(Y\) does not fit many of the tying and bundling cases observed in practice;
- The independence of the demand curves for \(X\) and \(Y\) is essential to reaching Nalebuff’s result, and is difficult to reconcile with the assumption that the bundle will be bought by all purchasers of \(Y\);
- Other background assumptions are questionable. For example, the fact that the demand for \(X\) is inelastic, though this can intuitively be explained by the condition that the monopolist is the only player in that market. In addition, the assumption that a perfectly competitive market exhibits an inelastic demand is quite extreme.

Accordingly, as acknowledged by both Nalebuff (2004) and Whinston (1990), the impact of tying and bundling strategies on the relevant market cannot be easily determined \textit{a priori}, and a rule of reason appears more appropriate than a \textit{per se} rule – as a matter of fact, these authors do not analyse in detail the pro-competitive reasons for engaging in tying and bundling, but focus mostly on the strategic ones.

A similar view was also expressed by Jean Tirole (2005), who offers a number of justifications for differentiating between tying practices according to the nature of the products and the markets at stake. Tirole points out that: (i) when marginal costs are low (and fixed costs are high, as for information goods), bundling can reduce the price to near its lowest level if there is also the ability by competitors to differentiate in the tied market\(^2\). Moreover, the “multi-sidedness” of the tied product can be helpful to increase, in another way, the ability to differentiate in the market through the platform (as frequently happens in telecommunications markets). Bundling thus allows the metering of the demand and the market segmentation. Vice versa, when the marginal costs are high, the ability to differentiate is low and the product is not “multi-sided”, there is a high probability that the tie-in practice is going to harm competition excluding competitors from the tied market. This is mainly due to the fact that, in a market with huge fixed costs and almost-zero marginal costs (as markets for information goods), these fixed costs need to be recouped and the inability to differentiate can significantly harm competition deterring the entry or potentially leaving one player in the market who is going to recoup losses in the subsequent period.

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\(^{130}\) A Pareto improvement is an action that harms no one but it makes at least one person better off.

\(^{131}\) Tirole J. (2005), cit.
Another view of the potential harmful effects of tying comes from an article published in 2002 by Carlton and Waldman\textsuperscript{132}. The two authors further weakened the seemingly granitic statement of Chicagoans. Whinston’s assertion that tying can harm competition only when the monopolist’s primary good is not in fixed proportions can be false in a two-period model with upgrades and switching costs (for example, durables and consumables). It is convenient to tie also if there is a superior alternative complementary product whose use requires the primary product. In fact, an entrant, in period 1, with a superior complementary product can decide to enter, in the period 2, also in the primary market. For the monopolist, tying in the first period can increase the entry costs for both primary and complementary products. In this way, tying is a device to preserve the monopolistic setting in the primary market\textsuperscript{133}.

Other strategic arguments come up from the economic literature to address a different approach for tying. Carbajo et al. (1990) and Chen (1997)\textsuperscript{134} argue that (in different market settings; also in an oligopolistic market) tying can be a product differentiation device allowing market segmentation, hence restricting competition. The practice allows an increase in switching costs and marginal costs when products are homogeneous, eventually raising firms’ profits in the market (avoiding perfect competition or a mechanism of competition à la Bertrand\textsuperscript{135}). These circumstances will thus force consumers to engage in a practice that will lock them into those products\textsuperscript{136}.


\textsuperscript{133} Choi and Stefanidis extended this reasoning stating that tying reduces also the incentives for each entrant to innovate since the reduced probability of successful innovation in all of the markets (requirement to succeed the innovation project); Choi J. P. and C. Stefanidis, “Tying, Investment, and the Dynamic Leverage Theory”, 32 RAND J.ECON., 52-71 (2001).


\textsuperscript{135} A mechanism of competition à la Bertrand is a one-shot oligopolistic game in which two firms end up competing through independently and simultaneously choosing the selling price. Considering other assumptions - as products’ homogeneity, no capacity constraints and identical marginal costs (no fixed costs) – the unique price of equilibrium is the price of the perfect competition, which is at marginal cost. Although there are two firms, with these conditions, the oligopolistic setting will end up to price at marginal cost, getting zero profits. See Motta (2004).

\textsuperscript{136} While Tirole’s analysis focused on the risk that the rivals’ ability to differentiate in a low-marginal costs (high fixed costs) setting is low, Carbajo et al. (1990) and Chen (1997) mainly focus on a “standard” marginal costs setting which, deviating from the homogeneity of the product, can help to segment the market and restrict competition. In effect, following Tirole’s view, the degree of foreclosure in the tied market is related to the dimension of marginal costs. A setting of high marginal costs increases switching costs, making harder to switch between products, unless the benefits of competitors’ product is extremely high. Therefore, tying or bundling help competitors’ foreclosure, potentially increasing barriers to competition. In a low-marginal costs setting (e.g. software products and so on), however, switching between products can be less expensive but competitors need to price over marginal costs to recover the high fixed costs. Tying, in this case, can be a way to sell close to the marginal cost (predatory strategy) and to finally reap the benefits of the
The figure below summarizes the features of the models described above by specifying the underlying assumptions on the market conditions assumed by the authors. The market’s settings can be shaped through the effects of low or high marginal and fixed costs, switching costs (and lock-in effects), product multi-sidedness, information asymmetries, etc, in a way to adapt the analysis also to market settings in which there is not a monopolistic or perfectly competitive background but the effects of these features can almost recreate the same conditions of these two strong prepositions

**Figure 17 – Relevant Models**

![Diagram of relevant models](image)

Source: authors' elaboration.

following market monopolisation. It can also be a way to differentiate products and sustain a static competition between multiple firms (tacit collusion) as an alternative to market monopolisation strategies.

Although dominance or at least “economic power” (as in Kodak case) in one of the two markets seems still to prevail in the economic literature and in the current jurisprudence, there is also a growing literature performing models to analyze the anti-competitive effects of tying practices in a context of limited competition for the tied and tying markets, in Kobayashi, Bruce H., “The Economics of Loyalty Discounts and Antitrust Law in the United States”, *1 Competition Pol'y Int’l 115* (2005). Economides, for example, examined bundling practices in this market setting (duopoly) and showed that, with perfect complements, the dominant strategy is a mixed bundling, while, with perfect substitutes, bundling brings an inefficient outcome due to a Prisoner’s Dilemma effect. See Economides Nicholas, Mixed Bundling in Duopoly, *NYU Stern School of Business, WP EC 93-29* (1993); Matutes Carmen and Pierre Regibeau, “Compatibility and Bundling of Complementary Goods in a Duopoly”, *40 Journal of Industrial Economics*, pp. 37-54 (1992); Nalebuff B., “Competing Against Bundles”, in Peter Hammond & Gareth Myles, Eds., *Incentives, Organization, And Public Economics*, (Oxford U. Press 2000).
1.1.1.3 Post-Chicago theories and other efficiency-enhancing features of tying and bundling practices

The latest developments of economic literature on tie-in sales led the Chicagoans to rethink their theories and to find new insights about tying practices. This has led to a more flexible approach to these practices, which confirms the tendency of the economic theory toward the adoption of a rule of reason approach. For example, as recently explained by Choi (2004),

“the welfare implications of tying arrangements are in general ambiguous because tying could have efficiency effects even when it has harmful exclusionary effects.”

Tying as a price discrimination mechanism is not the only likely efficient effect of these practices. In the last decade, many scholars have focused on the efficiency and pro-competitive effects of bundling and tying strategies. There are (other than the price discrimination) four main areas on which tie-in sales can act as a way to improve efficiency:

- **Economies of scale and scope.** These economies can emerge in both distribution and production processes. In particular, tying can allow firms to cross-subsidise highly demanded products and “niche” products – as in block booking and full line forcing – or better managing sales. In addition, tying can reduce costs of packaging and distribution, leading to economies of scale. It involves savings also for consumers, especially those ones who have a high reservation price for both products. In this respect, tying can lead to demand-side advantages such as “one-stop-shop” effects.

- **Reduction of information and transaction costs.** For instance, a newspaper satisfies different consumer preferences (news on sports, politics, etc) involving a sort of “one-stop-shop” effect and reducing potential transaction costs that would come out if every single item would have to be purchased one by one. In many cases, producers are better informed than consumers on components to bundle. Moreover, tying can be also a way to signal the quality of the new product bundled to the old one, already known, to preserve the reputational capital with the new one. In the financial services sector, cross-selling

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140 Choi (2003), cit.
strategies can help to improve the risk management by assuring a more efficient flow of information from the customer to the bank. For example, in a recent paper on investment services, Laux and Walz (2009) show that cross selling can increase underwriters’ incentives and even reduces rents in the underwriting business.\textsuperscript{141}

- **Avoiding double marginalization**\textsuperscript{142}. A cross-selling strategy can also avoid the risk of double marginalization in two complementary markets. Already in 1838, Augustin Cournot showed that bundling could improve the profits of two monopolists selling complementary products.\textsuperscript{143} In effect, the practice leads to an inefficient equilibrium in which the firms do not take into account the impact of the cross-price elasticity and so firms and consumers can be better off if price would be lower (as it happens in the bundle). For instance, in case of complementary goods and prices set independently, the two monopolists of the complementary products will set price too high (monopolistic prices). A cross-selling strategy leads the two monopolists to a common understanding through a price reduction to reap the benefits of a soaring demand. Therefore, both firms and consumers will be better off, avoiding the inefficient outcome.

- **Quality improvements**. When certain components are marketed together the risk of inefficient outcome due to the asymmetric information is drastically reduced. In effect, in some cases, the producer might know the best way to combine specific products in a way to increase the quality that the final consumer would enjoy. It can be a profitable practice for the firm, which increases the reputational capital, while the final consumer enjoys the highest possible level of quality.\textsuperscript{144}

On the other hand, recent literature has also highlighted that tying arrangements, besides creating a potential restriction of competition, can also lead to other disadvantages for producers and consumers.\textsuperscript{145} For example, combining products may increase the complexity and indirect costs for producers due, i.a., to higher maintenance

\begin{enumerate}
\item Evans D. S. (2006), *cit.*
\end{enumerate}
and support costs; or increased risk due to the combination of risky products in financial services, which may lead to weaker risk management and lower transparency. Consumers, instead, can be generally harmed by tying practices in their freedom of choice, restricting their preferences to mix and match components.

### Finding #1

Tying and bundling practices create both benefits and costs to society. This suggests a case-by-case approach to these practices, since the anti-competitiveness of the practice is strongly linked to the market context and the characteristics of the products involved. Recent economic literature suggests that factors such as high marginal costs compared to fixed-costs and lack of product differentiation can increase the likelihood that tying harms consumers.

#### 1.1.2 Tying and bundling under EC competition law

Tying and bundling constitute so-called “exclusionary” abuses under Community competition law. The main competition concerns in this respect are the potential for these practices to foreclose existing competitors and inhibit the entry of new players, leading to consumer harm. Under Community competition policy, tying is treated by case law mainly in case of single and collective dominance under Article 82 of the European Community Treaty (ECT). Based on the pre-Chicago rationale of the “leverage theory” illustrated above, the role of market power (“dominance”) in the tying or tied market is crucial in the analysis carried on by the European Commission and the EC Courts of these practices. This implies that the undertaking must be found to be dominant in at least one of the relevant markets involved.

Dominance is defined, under EC law, as

> "a position of economic strength enjoyed by an undertaking, which enables it to prevent effective competition being maintained on a relevant market, by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of consumers."

Therefore, the Commission defines a firm as “dominant”, with its “special

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146 A straightforward example is the famous merger GE\Honeywell prohibited by the Commission. The prohibition was principally based on the assessment of a potential “portfolio effect” that could result in non replicable bundles of complementary products, with a narrow definition of the relevant market See Case COMP/M.2220, General Electric/Honeywell, Commission decision of 3 July 2001; David S. Evans and Michael Salinger, “Competition Thinking at the European Commission: Lessons from the aborted GE-Honeywell Merger”, 10 George Mason Law Review 489, 520 (2002).

responsibility"\textsuperscript{148}, taking into account the following three factors\textsuperscript{149}:

1. The market position of the dominant undertaking and its competitors;
2. The existence of barriers to entry or expansion by actual and potential competitors;
3. The absence of a countervailing buyer power of the dominant undertaking’s customers\textsuperscript{150}.

Concerning market shares in Akzo\textsuperscript{151} the European Court of Justice established a 50% threshold to consider an undertaking to be dominant\textsuperscript{152}. In the 2008 Guidance document on the treatment of exclusionary abuses under Article 82, the Commission confirmed that it “considers that low market shares are generally a good proxy for the absence of substantial market power”; and that its experience suggests that “dominance is not likely if the undertaking’s market share is below 40% in the relevant market.”

The likelihood of anti-competitive foreclosure of potential entrants or actual competitors relies on the analysis of several aspects\textsuperscript{153}: the position of the dominant undertaking; the conditions of the relevant market; the position of the dominant undertaking’s competitors; the position of the customers or input suppliers; the extent of the allegedly abusive conduct; the possible evidence of actual foreclosure.

Therefore, the formal analysis of tying is based on a five-step assessment\textsuperscript{154}:

- Test of dominance (mainly based on market share held by the undertaking) in the tying market;
- Identification of two separate products (assessed on the basis of “commercial usage” or on the observation of the existence of a separate demand\textsuperscript{155});

\textsuperscript{148} This responsibility facilitates the finding of an abuse and makes easier that an efficient behaviour, if concerning a dominant firm, should be considered harmful for competition without “efficiency defence”; Case 322/81, Michelin v. Commission, § 10 [1983] ECR 3461.


\textsuperscript{152} In Hilti, the Commission narrowed the relevant market so much to split it into three different markets and it found Hilti dominant in every market, condemning the firm for unlawful bundling practice. See Case IV/30.787, Eurofix-Bauco v. Hilti (1988) OJ L65/19. Clearer situation for Tetra Pak II and Microsoft (tipping through windows media player), a typical case of leveraging through tying (technological tying for Microsoft); case IV/31.043 Elopak v. TetraPak (1992) OJ L72/1.

\textsuperscript{153} European Commission (2009), cit., p. 8-11.


\textsuperscript{155} The Court defines commercial usage narrowly and, to establish it, it is not sufficient that the tied
• Assessment of the coercion factor (i.e. customers are forced to buy tied products);
• Assessment of the anti-competitive effects (not clearly confirmed by case law\textsuperscript{156});
• Evaluation of any exceptional justification or efficiency (reducing transaction costs and so on) for tying to exist.

Tying can be also seen as a predatory pricing strategy (with many similarities with the vertical \textit{price squeeze}). As clarified by the Commission in its recent Guidance paper on Article 82, a multi-product rebate can be anti-competitive on the tying and tied market if the competitors, producing just one component, cannot compete against the discounted bundle\textsuperscript{157}. The long run average incremental cost\textsuperscript{158} (LRAIC) is the parameter to measure the predation’s aim. As stated by the Commission’s Guidance paper,

\begin{quote}
\textit{“If the incremental price that customers pay for each of the dominant undertaking’s products in the bundle remains above the LRAIC of the dominant firm from including this product in the bundle, the Commission will normally not intervene since an equally efficient competitor with only one product should in principle be able to compete profitably against the bundle”}\textsuperscript{159}
\end{quote}

Where firms compete “bundle against bundle”, the attention is on the price of the bundle as a whole and on the effect of this price on the possibility to compete by sellers of one product. This “equally efficient competitor” test must be carefully applied, in order to avoid that firms are punished for having lower costs (and consequently prices) than its rivals. In general, a firm should not be punished for having lower costs and so prices than its rivals.\textsuperscript{160} However, as mentioned above, bundling can be a way to enforce

\textsuperscript{156} In British Sugar, the Commission did not accept this test, while, in Hilti, the Commission confirmed that the elimination of the possibility to buy the tied product was an abusive exploitation (if there is a restriction of consumer choice, there should be no evaluation of the foreclosure effects, enacting a per se prohibition). See Napier Brown v. British Sugar, Commission Decision 88/519/EEC, 1988 O.J. (L 284) 41; Eurofix-Banco v. Hilti, \textit{id}.

\textsuperscript{157} European Commission (2009), \textit{cit.}, p. 19.

\textsuperscript{158} The LRAIC is a good proxy of the average total costs (ATC), since it represents the average of all the (variable and fixed) costs that a company incurs to produce a particular product.

\textsuperscript{159} European Commission (2009), \textit{cit.}, p. 19 § 59.

\textsuperscript{160} See Posner Richard A., \textit{Antitrust Law}, The University of Chicago Press, Chicago, 2\textsuperscript{nd} ed., 2001 (stating
exclusionary strategies, such as predatory pricing. Therefore, the legitimate aim to encourage efficient entrant should be balanced with the risk coming from exclusionary strategies.

In summary, a multi-product rebate\textsuperscript{161} may be found to infringe Article 82 if a firm holding a dominant position in at least one of the bundled products offers it. On one hand, if competitors offer a subset of the products included in the bundle or only one product, the LRAIC of these latter products will be compared with their price in the dominant firm’s bundle. On the other hand, if competitors can replicate the bundle, the price-cost test will be run on the whole bundle instead of the individual products in the bundle\textsuperscript{162}.

1.1.3 US approach to tying and other potentially unfair commercial practices

For the purposes of assessing the impact of policy on cross-selling practices, a “natural experiment” is provided by the US experience, where anti-tying restrictions have been enacted since the 1970s. Cross-selling strategies have been for long time and are, still today, part of a heated debate not only in the economic literature but also in the US and EC case law. In the United States, tying is covered by four laws\textsuperscript{163} plus a specific regulation in the banking sector:

- Section 1 of the Sherman Act (prohibition of contracts in restraint of trade)\textsuperscript{164};
- Section 2 of the Sherman Act (monopolization)\textsuperscript{165};
- Section 3 of the Clayton Act (arrangements that “substantially lessen competition; in the special sectors of goods, wares, merchandise, machinery, etc)\textsuperscript{166};
- Section 5 of the Federal Trade Commission Act (prohibition of “[u]nfair methods

\textit{that “It would be absurd to require the firm to hold a price umbrella over less efficient entrant [...] because we want to encourage efficiency”}.

\textsuperscript{161} A multi-product rebate refers to the cross-selling strategy of giving a big discount on one product when the consumer buys a specific quantity of another product. The practice is harmful when firms with relevant market power and through a predatory rebate enact it. See Choi (2003), cit.

\textsuperscript{162} In addition, if competitors can offer a sub-set of the bundled products, it makes sense to run the test on this subset of products. See, \textit{i.a.} CEPS, \textit{The Treatment of Exclusionary Abuses under Article 82 EC Treaty}, Report of a CEPS Task Force, forthcoming, July 2009.

\textsuperscript{163} See US DOJ (2008), \textit{id}.


\textsuperscript{165} \textit{Ibid.} § 2.

\textsuperscript{166} \textit{Ibid.} § 14.
of competition”)\textsuperscript{167};

• Section 106 of the Bank Holding Company Act of 1970 (anti-tying provisions)\textsuperscript{168}.

In this section, we briefly illustrate the treatment of tying and other potentially unfair commercial practices in US antitrust.

1.1.3.1 Tying and similar practices in US antitrust law

Tie-in practices have mainly been treated as a restraint of trade (contractual) or as a conduct to monopolize a market, respectively under Section 1 and 2 of the Sherman Act\textsuperscript{169}. Under this regulation, the jurisprudential treatment of tying arrangements seems to have moved from a “per se rule” illegality\textsuperscript{170} to a “rule of reason” approach\textsuperscript{171} through a “modified per se rule” in assessing, case-by-case, the anticompetitive effects of these practices, following the route drawn by the economic literature\textsuperscript{172}.

The whole point of the per se illegality is to avoid expensive individualized inquiries concerning competitive effects […]. The use of an anticompetitive effects requirement probably reflects considerable doubts about the wisdom of the per se rule. (Hovenkamp, 1999, p. 393)\textsuperscript{173}

However, Jefferson Parish\textsuperscript{174} “modified per se rule” still holds as dominant legal doctrine for tying. This idiosyncratic per se approach in Jefferson Parish consists of some steps to assess the anti-competitiveness of a tie-in practice. The steps are:

\textsuperscript{167} Ibid. § 45(a)(1).


\textsuperscript{169} See US DOJ (2008), id.

\textsuperscript{170} Standard Oil Co. Of Cal. V. United States (Standard Stations), 337 U.S. 293, 305-06 (1949).

\textsuperscript{171} Although the Court stated that its approach was explicitly referred to the specific sector of “platform innovation for PCs, network computers and information appliances”, Microsoft III defines, for the first time, a rule of reason approach for tying arrangements. However, this case was different from the regular cases usually addressed by the Supreme Court: it is a controversial case of technological integration (complex evaluation) and the tying was deemed as value-enhancing both for producers and consumers. United States v. Microsoft Corp., 253 F.3d 34 [Microsoft III] (D.C. Cir. 2001); see Ahlborn et al. (2003), Id.

\textsuperscript{172} The US Department of Justice, for example, “[…] believes that the historical hostility of the law to tying is unjustified. In particular, the qualified rule of per se illegality applicable to tying is inconsistent with the Supreme Court’s modern antitrust decisions and should be abandoned”. See US DOJ (September 2008), Chapter 5, id.


1. Existence of two separate products\(^{175}\);
2. Existence of economic power in the tying market\(^{176}\);
3. Influence on a “not insubstantial” amount of interstate commerce\(^{177}\).

The existence of economic power is a condition to verify another essential point in the analysis of tying practices: coercion\(^{178}\). The economic power to assess a restraint of competition\(^{179}\) and the potential subsequent coercion on consumers’ choice are usually evaluated through the market share, without setting a specific market share threshold, just a “sufficient” one\(^{180}\). It is also true that a mere evaluation of market share cannot give any evidence of coercion and it can provide courts with a misleading view of a firm’s ability to force consumers into the tie-in sale. For instance, in Kodak, the Supreme Court - confirming the Jefferson Parish’s “modified per se rule”- found Kodak guilty of an illegal tying practice with a market share of only 20% on the primary market\(^{181}\). In its judgment the Supreme Court let prevail an analysis of lock-in effects for consumers, due to relevant information asymmetries. Therefore, the economic power, coming from the lock-in effect on consumers, recreated a similar market setting where the tying firm benefits from the dominant position (the effect is the same). The market share is just a fictitious aspect if consumers are not allowed to freely choose and access the product’s substitutes to boost competition in the market. In economic theory, the market power is not a sufficient condition to experience anticompetitive effects\(^{182}\). In fact, the progressive distance between the notion of “sufficient market power” and “dominance”, in its common meaning, has reduced the critical relevance of market share in the US approach. The incidence of other factors on the definition of market power is straightforward to analyze the anticompetitive effects of tying practices.

Another aspect is the uniqueness of the practice. The practice should not be replicable by other competitors. However, it is not such a valuable condition if the market is segmented due to the lock-in effect and switching costs in an oligopolistic market setting. In effect, the replicability of the practice become irrelevant if the market is

\(^{175}\) “Separate products are defined to be those where consumer demand exists for the stand-alone products outside of the bundle”, Kobayashi (2005), id., p. 4.

\(^{176}\) In Fortner II, the Court mentioned a requirement of economic power in tying market; United States Steel Corp. v. Fortner Enterprises, Inc., 429 U.S. 610 (1977) (hereinafter “Fortner II”).


\(^{178}\) Jefferson Parish (1984), id.

\(^{179}\) Northern Pacific Railway Co. v. U.S. 356 U.S. 1 (1958). However, the dominance test and the coercion test are two separate tests, even though in their implementation they are commonly seen as a single test.


\(^{182}\) Ahlborn C. et al. (2003), id., p. 5.
structurally segmented and the competitor cannot enact the practice in the targeted market.

Concerning the anticompetitive effects, it was not required by Jefferson Parish to make this test. However, this test is frequently implicit in the assessment of economic power and power to coerce. In fact, this test would confirm the inefficiency of per se rule standard. The US Department of Justice (DOJ), in line with the modern Supreme Court jurisprudence under Section 1 and 2 of the Sherman Act, prefers as “second best” a costly disproportionality test, i.e. a way to analyze the trade-off between pro-competitive and anti-competitive effects. In fact,

"the Department will continue to work to develop conduct-specific tests and ‘safe harbors’. However, in general, the Department believes that, when a conduct-specific test is not applicable, the disproportionality test is likely the most appropriate test identified to date for evaluating conduct [...]".\textsuperscript{183}

The Supreme Court recently acknowledged that “many tying arrangements ...are fully consistent with a free, competitive market”\textsuperscript{184}. In another case, the Supreme Court argued that a per se rule standard is appropriate if courts have sufficient experience with a practice to determine with confidence that the practice is anti-competitive in all circumstances. Therefore, if there is a “limited” official adoption of a rule of reason with Microsoft III, in the judicial treatment of disputes on tying a case-by-case approach (with an implicit analysis of anti-competitive effects) is already frequent use and the passage to the rule of reason is just a matter of time.

\textbf{1.1.3.2 \hspace{1em} The US ban on tying in the banking sector: few cases and systematic circumvention}

In the US, a specific anti-tying regulation is enacted in the banking sector. The Congress, in 1970, approved the Bank Holding Company Act (BHCA) and in particular the Section 106 (12 U.S.C. § 1972) concerning the prohibition of tying arrangements in investment and banking services performed by banks. A bank shall not “extend credit” or “furnish any service” on the condition or requirement that the customer shall obtain some additional credit or other specific banking products. The Federal Reserve Board (Fed) then defines exemptions, whenever they consider a specific practice “usual”, without lessening the purposes or substantially modifying the structure of the anti-tying provision.

There are three conditions for the application of Section 106 of the BHCA:

\textsuperscript{183} US DOJ (2008), \textit{id.}, p. 11.

• The tying arrangement;
• The “unusual” requirement;
• The benefits for the bank (the bank should benefit from the tying arrangement).

The coercion is not a requirement for the application of this regulation.

In 1999, the Gramm-Leach-Bliley Act\(^{185}\) weakened, however, the content of the BHCA through the possibility for financial institutions to operate as fully diversified financial organizations (through ad hoc subsidiaries). The act led those institutions to offer an array of banking and non-banking products to customers (through the subsidiaries not considered “banks”), lessening the strength of the “unusual” requirement and increasing the possibility to reach economies of scope or the same result of a tying practice but circumventing the BHCA regulation. In effect, few cases of tying have been detected since 1970\(^{186}\) and additional steps for a sound enforcement should be taken\(^{187}\).

On one hand, anti-tying provisions are mainly justified with the risk to compromise the safety and soundness of the main banks’ liabilities (deposits) insured by the Federal Government. In effect, tying or bundling could be a way to extend banks activities in other businesses, exposing these deposit-based institutions to risks not properly related with their core services. The instability of these institutions thus might hamper the financial sector and so the financial stability at a systemic level. In addition, some argued that tying restrictions are merely a way to offset the competitive advantage that banks enjoy through the access to discounted credit lines and credit insurance of the central bank, but they should be subject to stricter regulation and supervision. Then, the FED confirmed that tying in banking “may force customers to take unwanted in order to obtain needed services, primarily loan products”\(^{188}\).

On the other, over the past few years – and mostly before the financial crisis – the debate over the need to relax anti-tying restrictions has become hectic. Many commentators have argues that such restrictions hampered banks from engaging in beneficial agreements with customers, with the result that important benefits (mostly from one-stop-shop efficiencies) would be foregone.

Lastly, several reasons explain why just few cases of tying have been detected since 1970 and then favoured the circumvention with the GLBA in 1999. Firstly, there is customers’ reluctance to report violations since they fear that their personal

\(^{185}\) GLBA; Pub. L. No. 106-102, 113 Stat. 1338.


relationship with the bank would be jeopardized or simply because they do not know that they may obtain credit or buy products at least with the same terms or price somewhere else (feeling the pressure of their own bank on eventually taking the financial product or service out\textsuperscript{189}). Secondly, there is a clear difficulty in identifying evidences of illegal tying in related documentation. In addition, without a specific objection it is hard to know where looking for evidences (GAO, 2003). Last but not least, the GLBA (which made the circumvention “systematic”) was designed to horizontally enhance competition in financial services and to encourage financial institutions to generate economies of scope or cost savings\textsuperscript{190} to sustain the financial and economic growth of the whole American banking, insurance and investment services markets.

<table>
<thead>
<tr>
<th>Finding #2</th>
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<tbody>
<tr>
<td>In Community competition law, tying and pure bundling are considered as exclusionary abuses whenever the firm that engages in these conducts is dominant in the tying market, the two products are separate, the conduct is likely to lead to anti-competitive foreclosure, and there are no significant efficiencies specific to the conduct.</td>
</tr>
<tr>
<td>A multi-product rebate may infringe Article 82 if a firm holding a dominant position in at least one of the bundled products and whether competitors cannot replicate the bundle or the single product offer, as the LRAIC test on the whole bundle or single offer shows anticompetitive advantages.</td>
</tr>
<tr>
<td>In the US jurisdiction, tying and bundling are currently treated with a rule of reason. In particular, tying is defined as practices capable to restrict competition (e.g. monopolization practice) when there are originally two separate products, the economic power (which does not imply a specific share of the market, as it is a measure of coercion), and the substantial influence on the interstate commerce. Bundling is mainly treated as multi-product rebate and it falls under the requirements set for predatory practices by the Areeda and Turner test (i.e. comparison of prices with the average variable costs [AVC] and assessment of possibilities to recoup).</td>
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\subsection{1.1.4 Preferential or exclusive agreements}

Firms imposing an exclusive dealing arrangement require customers to buy a certain product or service from a specific supplier. This practice often involves the agreement on a contractual term under which the buyer commits not to purchase an additional product from the supplier’s rival\textsuperscript{191}. This obligation may be induced by a preferential or

\textsuperscript{189} Litan [2003], cit.

\textsuperscript{190} Litan [2003], cit.

exclusive agreement between the supplier and a specific provider or because the firm is one of the same group. Such a practice is often observed in business-to-business contracts (B2B) to avoid dealer’s risk of free riding but it is also observed in a business to consumers (B2C) framework. This contractual practice is helpful in presence of “free-rideable” investments to assure high quality standards in the provision of the final product or economies of scale and scope. In effect, to guarantee investments in pre-sale services and an efficient provision of information, an exclusive agreement can help the seller to avoid that the buyer will free-ride on her investments, for instance, using the pre-sale services from a specific seller and purchasing the product or service from another one. This is usually a common practice in B2B frameworks (producer and distributor).

The antitrust economics of exclusivity suggest that sales conditional to exclusivity should not be considered as per se unlawful, as they can promote investment by making demand and supply more predictable and by reducing free-riding by rivals who may benefit from a firm’s investments. Pro-competitive justifications for exclusive dealing include, for the demand side, supply assurance, protection against price fluctuations, and facilitating long term planning by reducing risk; from the supply-side, the reduction of selling expenses, protection against price fluctuations, etc.

The traditional “Chicago” view of exclusive dealing arrangements in antitrust implied that such practices do not pose a threat to competition because a buyer will agree to exclusivity only if the arrangement delivers more surplus than alternative arrangements, including non-exclusive deals. According to Judge Robert Bork,

“there has never been a case in which exclusive dealing or requirements contracts were shown to injure competition. A seller who wants exclusivity must give the buyer something for it. If he gives a lower price, the reason must be that the seller expects the arrangement to create efficiencies that justify the lower price. If he were to give the lower price simply to harm his rivals, he would be engaging in deliberate predation by price cutting, and that . . . would


Nevertheless, they can also raise prices and lower consumer welfare by foreclosing a market to rival firms. For example, authors show that the bargaining model that is the core of the Chicago analysis (i.e., that buyers will accept an exclusive relationship only if it is the most efficient) can break down if there are many uncoordinated buyers. Their model has been extended by Segal and Whinston (1997), who show that their reasoning applies with even greater generality when the seller can price discriminate and bargain sequentially with customers.

In our opinion, under EC competition law preferential and exclusive agreements – as we defined them – might be construed as falling into the category of abusive discrimination, and as such could potentially be subject to article Art. 82(c) ECT, which prescribes that a dominant undertaking should not apply dissimilar conditions to “equivalent transactions”. These types of practices would in any case fall outside the Commission Guidance paper, which explicitly focuses on exclusionary abuses. However, the application of Article 82(c) ECT to cases of abusive discrimination has so far mostly concentrated on cases in which the dominant undertaking was a legal monopolist, or as a part of a broader series of abusive conducts by a dominant undertaking, as in the case of, i.a. Irish Sugar.

Finding #3

Preferential or exclusivity agreements in the retail financial services sector could in principle be framed as abusive discrimination, but they are unlikely to be captured by Article 82(c).

1.2 Other potentially unfair commercial practices as exclusionary abuses in competition law

Apart from tying and bundling, this paper looks also at other potentially unfair commercial practices such as conditional and loyalty rebates, preferential or exclusive agreements and aggressive commercial strategies. Of these practices, some may fall

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197 T228/97, Irish Sugar v. Commission, [1999] ECR-II 2969, para. 188.
under the scope of antitrust law, besides being potential matter for consumer protection: this is undoubtedly the case of rebates and exclusive dealing agreements, but may also occur in the case of conditional sales.

Although the 2008 Guidance paper does not mention other potentially unfair practices that may be relevant for the purposes of this Report, in our opinion the paper provides a relevant background with a general test that may apply to all observed practices, whether alone or in combination with other conducts, even though not explicitly mentioned by the Commission’s paper.

The test requires that the observed conducts lead to (or are likely to lead to):

- Foreclosure of “as efficient competitors” or – under specific circumstances – even “not yet as efficient competitors”.

- An adverse impact on consumer welfare, “whether in the form of higher price levels than would have otherwise prevailed or in some other form such as limiting quality or reducing consumer choice”\(^{198}\).

In this respect, the Commission clarifies that the main goal of the application of Article 82 to exclusionary abuses is indeed the protection of consumers, rather than competitors\(^{199}\). Moreover, in the Guidance paper the Commission identifies a number of factors that might be considered relevant in the assessment of dominance\(^{200}\), as well as factors that may be taken into consideration in assessing the likelihood that an observed conduct by a dominant undertaking is likely to lead to anti-competitive foreclosure\(^{201}\). The Commission puts emphasis on a more sound economic approach to exclusionary abuses.

It also clarifies that, depending on the circumstances, actual proof of anti-competitive foreclosure may not be needed, and that the mere “likelihood” that a conduct leads to anti-competitive foreclosure could form the basis for a finding of abuse. For example, the Commission states that

\(^{198}\) See Guidance Paper, §19.

\(^{199}\) Id., para.6, stating that “the Commission is mindful that what really matters is protecting an effective competitive process and not simply protecting competitors. This may well mean that competitors who deliver less to consumers in terms of price, choice, quality and innovation will leave the market”.

\(^{200}\) Id., para.12. These factors include: (i) the market position of the dominant undertaking and its competitors; (ii) constraints imposed by the credible threat of future expansion by actual competitors or entry by potential competitors; and (iii) constraints imposed by the bargaining strength of the undertaking’s customers (countervailing buyer power).

\(^{201}\) Id., para.20. These factors include: (i) the position of the dominant undertaking; (ii) the conditions on the relevant market; (iii) the position of the dominant undertaking’s competitors; (iv) the position of the customers or input suppliers; (v) the extent of the allegedly abusive conduct; (vi) possible evidence of actual foreclosure; and (vii) direct evidence of any exclusionary strategy.
“[t]here may be circumstances where it is not necessary for the Commission to carry out a detailed assessment before concluding that the conduct in question is likely to result in consumer harm”, and that “[i]f it appears that the conduct can only raise obstacles to competition and that it creates no efficiencies, its anti-competitive effect may be inferred”202.

In other words, the standard of proof for a finding of abuse is likely to change according to the circumstances of the case: truncated analyses and presumption of anti-competitive behaviour will thus be important in the future treatment of exclusionary abuses under EC competition law.

The figure below illustrates in graphical terms the general approach adopted by the Commission in the Guidance Paper. It is unclear, however, how this test should proceed when the conduct may foreclose an as-efficient competitors but it does not consistently affect consumer welfare.

**Figure 18 – The General test adopted in the December 2008 Guidance Paper**

**Finding # 4**

In our opinion, any commercial practice by a dominant firm may be configured as an anti-competitive practice under article 82 of the EC Treaty if it leads to actual or likely foreclosure of rivals, harms consumers in the long run, and does not show sufficiently strong redeeming efficiencies.

202 *Id.*, para.22.
1.2.1 Conditional sales practices

1.2.1.1 Conditions attached as essential for the conclusion of the contract

A firm may decide to impose an essential condition for the purchase of a given service. Such conditions may relate, for example, to the payment of the salary into the current account that is linked to a mortgage loan. From the standpoint of competition policy, in principle conditional sales do not lead to an exclusionary abuse, especially when competitors can replicate the same practices, regardless of their scale.

However, under certain circumstances this type of practice can work in the same way as an exclusive dealing arrangement: for example, by requiring the customer to have the salary paid into a current account linked to a mortgage loan (the so-called “current account mortgage” practice), a mortgage lender is indeed limiting the attractiveness of competing offers by alternative current account providers, as the customer would not be able to fully profit from better contractual conditions, if the bulk of his savings are in the current account linked to the mortgage loan. Put differently, for many consumers there can only be one “main” current account: tying the “main” account to the mortgage loan also means requiring quasi-exclusivity in current account usage, and thus may foreclose as-efficient competitors in the market for current accounts. As a matter of fact, if a customer has committed to have the salary paid into a given current account, it may be impossible for a more efficient entrant to attract that customer to its own services: this is an example of cases in which contracts may act as barriers to entry.

In competition policy, an exclusive dealing agreement can have harmful effects on consumers especially when enacted by a dominant undertaking\(^\text{203}\), since it can induce to pass on consumers the increased costs borne by the counterparty in the B2B framework. It may have the immediate effect of preventing the entry or the expansion of competing undertakings, once the following factors have been considered:

- The harm suffered by the customer (e.g., opportunity costs);
- The market structure (e.g., contestability, switching costs, etc);
- The extent of the foreclosure effect;
- The duration of the contract at the issue;
- The success in raising rival’s costs\(^\text{204}\);

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• The business justifications;
• The role of potential competitors\textsuperscript{205}.

This practice can be enacted - also by non-dominant undertakings - in the B2C relationship to further increase customers' switching costs and to exploit in a more efficient way lock-in effects. It may eventually reduce customers' mobility and freedom of choice, so objective justifications (as to preserve relevant pre-sale investments) need to be shown in order to consider this practice "fair" (not harmful for customers).

In the Guidance paper on the application of Article 82 to exclusionary abuses, the European Commission clarifies that

"[t]he capacity for exclusive purchasing obligations to result in anti-competitive foreclosure arises in particular where, without the obligations, an important competitive constraint is exercised by competitors who either are not yet present in the market at the time the obligations are concluded, or who are not in a position to compete for the full supply of the customers"\textsuperscript{206}.

This is the case in particular when competitors are unable to compete for an individual customer's entire demand since the dominant firm is an "unavoidable trading partner", for example because its brand is a "must stock item" preferred by many final consumers or because the capacity constraints on the other suppliers are such that a part of demand can only be provided for by the dominant supplier. In effect, if competitors can compete on equal terms for each individual customer's entire demand, the Commission considers that

"exclusive purchasing obligations are generally unlikely to hamper effective competition unless the switching of supplier by customers is rendered difficult due to the duration of the exclusive purchasing obligation".

Finally, the Commission considers that the longer the duration of the obligation, the greater the likely foreclosure effect.

Against this background, under EC competition law a conditional sale agreement would be relevant only when it is likely to lead to anti-competitive foreclosure – \textit{i.e.} both foreclosure of competitors and consumer harm. In the case of conditional sales such as current account mortgages, it all depends on a number of elements, such as: (i) whether the current account on which the salary has to be paid is offered by a dominant

\textsuperscript{205} European Commission (2009), \textit{cit.}, §34.

\textsuperscript{206} \textit{Id.}, at §36.
mortgage lender or by an affiliated body; (ii) whether the conduct creates or is likely to create efficiencies on the side of the lender; (iii) the likelihood that these efficiencies are shared with customers in the form of better contractual conditions such as *i.a.* lower interest rates; (iv) whether the combined sale of a mortgage loan and a current account would have been exclusionary even without the additional condition of having the salary paid into that account; (v) whether transporting the mortgage to another lender is feasible, etc.

**Finding # 5**

Conditional sale agreements, such as the obligation to have the salary paid into a current account, normally do not create concern for antitrust authorities. However, in certain circumstances they can have an effect similar to that of exclusivity or preferential agreements, and as such may lead to the foreclosure of as efficient competitors, coupled with consumer harm.

### 1.2.1.2 Conditional rebates as an antitrust infringement

A supplier can induce consumers to purchase all or part of the sold products in different ways. In markets structurally affected by high switching costs, a discount system may help to capture new customers and subsequently charge them with higher prices (once locked-in or once competitors have left the market). A widespread discounting practice is the conditional rebate. They are "*granted to customers to reward them for a particular form of purchasing behaviour*"\(^{207}\). The scheme consists of a rebate on customer’s purchases if he or she meets a set target volume. This target can be a percentage of the total volume, a standardised level or an individualised amount on a set reference period. In addition, this non-linear discount scheme can be calculated as:

- A price cut on the incremental products or services over the threshold bought by the customers (incremental rebates)
- A rebate granted on all purchases in the reference period after the targeted volume has been bought (retroactive rebates)\(^{208}\).

The practice of granting single-product rebates is considered to be potentially very harmful for consumers, especially due to its loyalty-inducing effects and the consequent likelihood of anti-competitive foreclosure\(^{209}\). The legal analysis of conditional rebates is

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\(^{207}\) European Commission (2009), Guidance on the Commission’s enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings*, cit.*, §37.

\(^{208}\) We will refer to retroactive rebates while incremental rebates, due to the lower harmful effect, will be generally treated in the next paragraph.

usually carried out on the basis of article 82 ECT. It usually involves exclusionary and foreclosure effects similar to exclusive purchasing obligations whether enacted by dominant undertakings under specific conditions\textsuperscript{210}. The discount should be applied on a determined reference period. Three elements are relevant in a conditional rebate to assess the loyalty enhancing effect:

1. \textit{The level of the threshold}. The granting of a rebate is related to the achievement of a specific threshold volume. This volume can be standardised or individualised. An individualised amount easily allows undertakings to define a level to make it more difficult for customers to switch suppliers, creating a strong loyalty-inducing effect\textsuperscript{211}. The retroactive discounted basis involves a so-called suction effect\textsuperscript{212} around this targeted volume. In fact, when the threshold is set above the level that would be anyway purchased by the customers, it can induce them to buy a volume of products that they would not have bought in absence of retroactive rebates. Therefore, this loyalty-enhancing rebate (due to the suction effect) may be harmful, since it induces customers to make a level of purchases they do not want. It reduces the contested portion of the demand ("contestable share")\textsuperscript{213}, with a likely foreclosure effect on actual and potential competitors.

2. \textit{The reference period}. The length of the reference period is usually considered as a relevant factor for the efficacy of the rebate scheme\textsuperscript{214}. Rebates granted over a too short reference period are normally considered insufficient for the anticompetitive effect to materialise. However, such an aspect often cannot exclusively determine the loyalty-inducing effect and, according to the literature, in some cases the reference period may be irrelevant for the competition analysis\textsuperscript{215}.

3. \textit{The size of the rebate}. The extent of the rebate defines the likely foreclosure effect of the practice. Essentially, the predatory impact of the practice depends on the level of the effective price. In retroactive rebates, the average price of the overall volume should be considered. To evaluate the potential foreclosing impact of the

\begin{itemize}
  \item European Commission (2009), \textit{cit.}, §34.
  \item \textit{Id.}, §45.
  \item European Commission (2009), \textit{cit.}, §40-43.
  \item See European Commission (2009), \textit{cit.}, §37; the relevant case law, however, stated that a period of more than three months should be always considered as a requirement to consider the rebate \textit{per se} unlawful; see Case T-203/01 \textit{Michelin v. Commission (Michelin II)}, 2003 ECR II-4071.
\end{itemize}
rebate, the effective price should be compared with two measures of cost (Akzo test\textsuperscript{216}): the long run average incremental costs (LRAIC) and the average avoidable costs (AAC)\textsuperscript{217}.

**Figure 19 – The predatory impact of rebates**

As shown in the figure above, the exclusionary effect of the rebate depends on the exclusionary impact of the practice. The third outcome can be considered totally lawful, since other competitors can replicate the practice without incurring in loss. When the price is between LRAIC and AAC, the potential harmful effect on competition depends also on other factors, such as the market structure (high fixed costs industry), the time length of the practice and competitors’ likely counter strategies\textsuperscript{218}. Finally, in outcome 1, the practice can be considered extremely harmful for competitors, since it does not allow as-efficient competitors to offer services without incurring in losses, also in the short run. The rebate thus aims at foreclosing the market and charging higher prices.


\textsuperscript{217} The AAC, instead, is a good proxy of the average variable costs (AVC) if no fixed costs occur in the considered incremental products. In fact, the AAC is the average of the costs that could have been avoided if the company had not produced that amount of (extra) output; see European Commission (2009), cit, §26.

\textsuperscript{218} European Commission (2009). id, §44.
when other competitors are excluded. In addition, in the long run (multi-period model) also consumers will be harmed by higher prices, charged by the firm to recoup the resources employed to enact the practice in the first period.

Conditional rebates may have also efficiency reasons\textsuperscript{219}. These include:

- Direct benefits for consumers (consistent price reduction);
- Search for economies of scale (high fixed costs, need for greater consumption levels; e.g. trading fees’ plan in investment services);
- Second-degree price discrimination\textsuperscript{220};
- Reduction of inefficiencies;
- Protection of significant investments in the distribution channel, preventing free-riding by competing suppliers;
- Support to the firm recovering specific investments made to satisfy the needs of a particular customer (it helps to solve the hold-up problem)\textsuperscript{221}.

The European Commission clarified in its recent Guidance paper on exclusionary abuses under Article 82 ECT that

"[t]ransaction-related cost advantages are often more likely to be achieved with standardised volume targets than with individualised volume targets. Similarly, incremental rebate schemes are in general more likely to give resellers an incentive to produce and resell a higher volume than retroactive rebate schemes"\textsuperscript{222}.


\textsuperscript{220} Rebates can be a tool to efficiently price discriminate between consumers. In general, a second-degree discrimination occurs when “a firm offers different deals to everybody to let different customers to “self-select”, choosing one specific deal”. If correctly implemented this practice increases the total welfare in the market; see M. Motta (2004), cit., p. 492.


\textsuperscript{222} European Commission, Guidance paper, cit., at #46.
1.2.1.3 Loyalty rebates

A system of loyalty rebates can be put in place by competing firms. It is directed to specific groups of customers, mainly new customers. In effect, it may be used as a tool to catch new customers and to reap, once locked-in, the benefits from charging higher prices, so hampering consumer welfare\(^{223}\). Its potentially harmful impact increases with the market share. For example, the recent Commission case against *Intel*, which led to a fine of more than €1 billion, involved loyalty rebates conditional on quasi-exclusivity.

A loyalty discount scheme can be structured with more favourable contractual conditions (*e.g.*, a free credit card, a lower interest rate) without setting any threshold or target volume. It might be offered to customers with lower switching costs and more willing to move with a different supplier. In a multi-period model, in effect, it could be profitable for the firm to adopt a strategy “investing then harvesting”, also in a mature market. This is particularly true in specific situations: for example, when a firm – *e.g.* due to lack of sufficient information – cannot differentiate between new and existing (locked-in) customers for a given product or service, it can adopt rebates schemes aimed at attracting new potential customers and increasing the base of artificially inelastic customers (locked-in)\(^{224}\). The emergence of these schemes is also related to other aspects, such as the aggressiveness of competitors and the elasticity of the demand. Increasing the locked-in customer base for all the firms can reduce competitors’ aggressiveness in the following period. Vice versa, in a collusive framework a discount scheme can help to attract new customers and to deviate from the cartel agreement.

Finally, the elasticity of the demand may be a good tool to measure the likely impact of a rebate scheme and its efficiency to attract new customers. It may be used as third-degree price discrimination device to select between customers in relation to specific

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\(^{224}\) It would be extremely costly to make an analysis in depth of every single customer's specific characteristics (*e.g.* individual’s risk aversion), affection by switching costs, and potential locking-up effects. In effect, as described in the following paragraphs, switching costs have so many implications that it makes this analysis not pursuable. For instance, the huge number of customers and limited means to look into customers’ idiosyncrasies enhance this difficulty in banking and investment services.
characteristics\textsuperscript{225}. This kind of price discrimination can potentially increase the total welfare if the strategy can be “perfectly” adopted (no arbitrage for consumers). Other efficiencies of a loyalty “unconditional” rebate scheme match with the list in the previous paragraph.

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<th>Finding # 7</th>
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<tr>
<td>The overall impact of loyalty rebates depends on firms’ market shares, the competitive structure of the market and the characteristics of demand; incremental rebates often have a lower harmful impact than retroactive rebates, the size of the rebate being equal.</td>
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\textbf{1.2.2 Aggressive commercial practices in competition law}

Article 82 of the EC Treaty does not only cover exclusionary practices, but also so-called exploitative abuses, which are the result of the behaviour of a dominant firm that damages in \textit{primis} its customers. The Treaty clearly indicates that these practices consist of “directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions”. Accordingly, provided that the firm that applies the practice is dominant in its own relevant market, certain unfair practices could be conceived as exploitative abuses, which lead to lower consumer welfare and higher profit for the dominant firm. The impact of these practices on rivals, customer mobility and switching costs is normally only indirect: most often, the dominant firm is already shielded from competitive pressure, and accordingly decides to adopt a profit maximising strategy to the detriment of downstream customers.

The most common exploitative abuse is the practice of excessive prices. In particular, since the famous 1976 case \textit{United Brands}, the Commission has introduced a criterion that relates the “excessive” nature of the price applied by the dominant firm to the “economic value” of the product sold\textsuperscript{226}. Subsequent case law has broadly confirmed this approach, although some commentators have criticised it as leading, \textit{i.e.} to legal uncertainty, as the standard used to assess whether a price is excessive or not is very difficult to define\textsuperscript{227}. Can we measure the price of competition? So far, the antitrust treatment of excessive prices has focused on firms with a position of monopoly or very significant market power (the most famous cases being \textit{British Leyland}, \textit{General Motors}, \textit{Port of Helsingborg} and others); in addition, prices can be considered to be “excessive” when there is evidence of a very large price-cost margin and/or the comparison with

\textsuperscript{225} A third-degree price discrimination refers to “the possibility that a firm charges different prices to consumers having different (observable) characteristics”; see Motta (2004), \textit{cit.}, p. 492.

\textsuperscript{226} Case 27/76, \textit{United Brands Company v. Commission}, \cite{27/76} ECR 207.

\textsuperscript{227} See, \textit{i.a.} O’Donoghue and Padilla, \textit{cit.}, at 603.
prices prevailing in more competitive markets suggests that the firm at hand is largely abusing its dominance.

In our opinion, the antitrust treatment of exploitative abuses under Article 82(a) is not limited to excessive prices, but extends to other conducts, including unfair contractual terms. Community case law in this respect ranges from cases (such as BRT/SABAM and GEMA, both related to copyright collection societies) in which contract terms were considered abusive since they (i) were not "absolutely necessary for attaining the object of the contract" and (ii) unnecessarily and disproportionately limited the counterparty’s freedom of choice ("equity test"); to cases in which the unfair contract terms were only part of a much broader set of abusive conducts, such as Tetra Pak II. Finally, in DSD, the Commission clarified that a contract term may be seen as abusive

"where an undertaking in a dominant position fails to comply with the principle of proportionality"\(^\text{228}\).

Such criterion, according to two authoritative commentators, requires a balancing of "the object of the contract, the terms of the contract, and the contractor's justification for those terms"\(^\text{229}\).

The case law on exploitative contract terms under Article 82(a) EC Treaty never referred to practices such as unsolicited offers, churning and steering. The need to refer to clearly specified contract terms adopted by a dominant firm makes Article 82(a) difficult to apply to these practices. As will be explained in Section 2.2.1.1 below, the degree of competition is often unrelated with the emergence of these types of unfair commercial practices, especially in the case of services that are high on credence attributes, such as retail financial services. On the contrary, in some cases the increased cost pressure borne by financial advisors due to competition can lead them to adopt even more exploitative behaviour towards their customers.

**Finding # 8**

In our opinion, aggressive commercial practices such as unsolicited offers, churning and steering could in principle constitute an exploitative abuse under Article 82(a). However, the need to refer to clearly specified contract terms practiced by a dominant firm makes Article 82(a) very difficult to apply to these practices. As a result, it is unlikely that these practices can be adequately tackled by antitrust laws.

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\(^{228}\) DSD, OJ 2001 L166/1, para. 112.

\(^{229}\) O’Donoghue and Padilla, cit., at 654.
2. Tackling tying and other potentially unfair commercial practices in consumer policy

In this section, we provide an overview of the main reasons why the practices under analysis in this paper may be considered as potentially unfair and detrimental to consumers and SMEs in the retail financial services sector. In June 2005, the European Commission launched a sector inquiry into competition in financial services, pursuant to Article 17 of Regulation (EC) No 1/2003. The financial services sector inquiry focused on two main areas: retail banking (including payment cards) and business insurance. In the European Commission’s sectoral inquiry on retail financial services cross-selling strategies and more particularly bundling and tying of bank products were detected among other issues hampering competition in the sector. The interim reports also recalled some of the undesirable consequences of these practices, including the reduction of price transparency, the leveraging of market power into adjacent markets, and entry deterrence. The final report of the sector inquiry was published on 31 January 2007. This final document builds up on the preliminary findings of the interim report by providing new insights and features depicting tying practices across the EU. Some conclusions can be easily drawn:

(i) The product structure of tied bundles shows that “the practice of current account tying appears to be widespread in the EU retail banking sector, whether purchased alongside a mortgage, consumer loan or SME loan. (…)The overall incidence of tying appears to be highest for SME loans.”

(ii) Tying practices are more spread within the group composed by new Member States, as result of their intent “to promote the banking sector growth and development.”

(iii) Smaller and foreign banks seem to be influenced by the conduct of tying by larger banks and mirror their practices.\(^{230}\)

(iv) Banks argued that tying allows them to reduce significantly their credit risks and enable them to benefit from economies of scope, which could then be passed on to consumers through price reductions. The inquiry questioned the transmission of benefits to consumers to the

\(^{230}\) To illustrate this, out of eleven Member States in which its largest mortgage banks tied a current account to its mortgage hook product, nine countries exhibit the case for smaller banks mirroring this practice. Other tied bundles (i.e. current accounts tied to personal loans) show a similar pattern. In addition and regarding the case for foreign banks, the final report states the following: “the evidence also suggests that some foreign banks adapt their tying and bundling strategy according to domestic competitive conditions. […] This suggests that the commercial rewards to foreign entrants are greater from following this type of conduct […]. Thus a high proportion of product tying in a particular Member State is likely to be self-reinforcing, weakening the impact of new entrants on competition.”
extent that many practice involve only the duplication of services and costs for consumers (even though price reductions could be possible).

The impact of the practices at stake on consumer choice and mobility may be high even absent a significant degree of market power on the side of the financial services provider.

The section below describes the main reasons identified by the economic theory for protecting consumers and SMEs against unfair commercial practices. In particular, we identify the specific characteristics of the retail financial services sector, which have specific attention by the policymaker. These include informational asymmetries (including limited effort in “shopping around” and limited financial education of customers), transaction-specific investments and bounded rationality. Section 2.2 analyses more in detail the determinants of switching costs for consumers and the available evidence on customer mobility in retail financial services compared to other economic sectors. Section 2.3 describes how practices under scrutiny – including cross-selling, conditional sales and aggressive commercial practices – can affect these market characteristics, and whether such impact is likely to prove unfair and detrimental to consumers and SMEs.

2.1 The rationale for protecting consumers and SMEs against unfair commercial practices

As acknowledged by the law and economics literature, consumer transactions differ noticeably from the standard paradigm of contractual relations, where parties stand on an equal footing in terms of information and bargaining power. The law and economics literature initially focused mostly on situations in which consumers adhere to a standard form contract offered on a “take-it-or-leave-it” basis. However, the attention of scholars in the past few years has focused also on the pre-contractual level, especially in cases where the informational asymmetry between the seller and the customer is such that the latter heavily depends on information provided by the former or may be not able to process that flow of information (rational ignorance or cognitive biases); and on the phase that follows the conclusion of a contract, when providers can exploit transaction-specific investments and customer lock-in in so-called neoclassical and relational contracts.

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As regards the pre-contractual phase, most of these situations may depend on the existence of an informational asymmetry between specialised players (e.g., a financial services provider) and non-specialised customers (consumers or SMEs). A basic tenet of consumer policy is that in business to consumer (B2C) contracts, consumers are often likely to be less informed than their professional counterparts, since the cost associated with the collection of information and understanding of contract conditions is often very high. B2C commercial practices are potentially exposed to the strategic behaviour of the better-informed part in the contractual relationship. Firms normally have more resources to undertake a better-informed transaction, and can spread the cost of acquiring information over a large number of transactions – there are indeed economies of scale in the collection of information on the side of service providers. In these situations, relatively uninformed customers (both consumers and SMEs) are left in a situation in which they are not effectively able to make a precise and informed decision on their contractual behaviour as well as on the existence of alternatives, and include cases in which the price and other conditions associated with a given transaction are not transparent; cases in which the information provided by the counterpart is not reliable or misleading; and cases in which the customer’s perception of the costs and benefits associated with the transaction are distorted.

Many of these problems are exacerbated whenever the quality of the good or service to be purchased by the customer is observable only after its use. This is the case of “experience” goods, as defined in the literature233. When consumers and SMEs buy experience goods, they may realise too late that their valuation of the product or service was mistaken or not realise it at all in case of credence attributes. This is too late especially when their effective ability to switch to alternative providers is limited. In

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233 Products and services can be classified in three categories: search goods; experience goods; and credence goods. A search good consists in a product or service for which is possible to assess the quality before the purchase. Search elements include those attributes of the relationship that are easily detected and understood by customers, even when they are deciding whether to switch to a competing provider. An experience good, instead, is a product or service for which the buyer can evaluate the quality only after the purchase and its use. Finally, a credence good is a product or service whose value and quality cannot be assessed even after its use, as features cannot be easily compared with other products or services. It is the “grey area” where customers do not have any knowledge of what is in the contract, and what it means in terms of its relationship with the provider. See Darby e Karni, Free Competition and the Optimal Amount of Fraud, 16 Journal of L. and E., 69 (1973); and Nelson, Information and Consumer Behaviour, 78 Journal of Pol. Econ., (1970).
these cases, the “barriers to exit” from an existing contractual relationship can be very high. In effect, cases in which exit barriers from a contractual relationship are very high may occur both due to the inherent characteristics of the market, but also due to the existence of specific commercial practices by sellers, which have the effect of increasing customer lock-in. In addition, some retail financial services (e.g., financial advice on mortgage loans or investment products) are characterised, as mentioned above, by high credence attributes, and this further weakens the position of customers, as it leaves them with the practical impossibility to observe the quality of the service they are being provided.

All these factors are relevant to the retail financial services sector. In fact, in this sector specific market characteristics suggest that the need for policies protecting consumers and SMEs is particularly strong. These specificities include:

- Informational asymmetries between providers and customers, including limited financial education;
- Bounded rationality and “structural” decision-making biases when facing risky investments\(^{234}\);
- Limited customers’ effort in “shopping around”;
- Customer lock-in and switching costs, including the existence of relationship-specific investments.

More will be explained in the next paragraphs in order to shed more lights on the concepts listed above and their relation with the consumer policy.

2.1.1 Informational asymmetry between providers and customers

The asymmetry of information between providers and customers in consumer contracts depends on what the economic literature refers to as “rational ignorance”, and is extensively studied in the consumer protection literature\(^{235}\). As customers (both consumers and SMEs) are normally not specialised in financial services, they have to trust their financial service providers, especially when dealing with investment choices involving complex risk calculations. This does not necessarily imply that customers’ rationality is bounded or distorted\(^{236}\); it simply means that the cost of acquiring full

\(^{234}\) For a definition, see below, note 137-138.

\(^{235}\) Rational ignorance occurs whenever an individual rationally chooses not to acquire all the information needed to conclude a contract. As was authoritatively observed, in a number of situations “the costs of becoming informed may exceed the benefit, resulting in rational ignorance of hidden traps in contracts that competition may not dispel”. See, e.g., Lucian A. Bebchuk & Richard A. Posner, One-Sided Contracts in Competitive Consumer Market, 104 MICH. L. REV. 827, 827 (2006).

\(^{236}\) Bounded rationality refers to the fact that human beings – contrary to what occurs in cases of rational ignorance – always take their decisions on the basis of imperfect information, limited
information on the features, alternatives and likely future values of today's investment products is greater than the benefit of acquiring such information.

Financial services are normally considered to be inherently intangible and with high experience and credence qualities\textsuperscript{237}. This is confirmed in the literature: for example, in a recent paper stating that

\begin{quote}
“\textit{From the perspective of information economics, financial advice (as a service offered by banks) has all the typical characteristics of credence goods} and \textit{most of the quality properties of financial advice—as the above suggests—can be considered credence characteristics whose quality—due to time or cost restrictions—can neither be inferred before nor after a decision has been made}”\textsuperscript{238}.
\end{quote}

This is due to several factors:

(i) financial advice is based exclusively on the advisor’s promise to perform his service, but this is highly ambiguous for the client at the time he enters the corresponding contract; this relationship is mainly fiduciary (based on trust);

(ii) financial advice giving and taking is cognitively very demanding to the involved parties due to the multitude of factors an investment decision must be based on, and their strong interdependence; and

(iii) due to its decisive role for the development of a client’s future situation and the necessity to closely cooperate with the client in developing recommendations, financial advice can also be considered of high value and specificity.


for customers to compare alternative offers and understand the value for money of a given contractual offer. In addition, the greater are experience and credence qualities, the lower is the interest for customers in shopping around for qualities they will never be able to appraise before actually signing a contract.

A typical example of “credence attribute” in retail financial services is the quality of customer service; in many cases, the competence of the personal advisor belongs to credence attributes, since customers will not be able to fully judge whether they are actually receiving high-quality advice or not. This opens up the possibility of unfair practices such as steering, as will be explained in the next paragraphs. Credence attributes also pave the way to “push” behaviour such as aggressive commercial strategies or unsolicited offers (e.g., “we know what’s best for you”).

In retail financial services, the information asymmetry between parties may raise two potential harmful common problems in retail markets (a typical principal-agent problem in fiduciary relationships\textsuperscript{239}): moral hazard and adverse selection.

- **Moral hazard**\textsuperscript{240} is an informational problem related to the opportunistnic behaviour of the more informed party, who tries to exploit the informational advantage and the scarce ability of less informed party to monitor the other’s activity.

- **Adverse selection**\textsuperscript{241}, instead, is an informational problem structurally related to the difficulty by one of the two parties to process some kind of information, such as the quality of the products\textsuperscript{242}. Furthermore, the opportunistnic behaviour of the party that is more informed about product quality helps to exclude virtuous practices


\textsuperscript{241} In Akerlof (1970), the classical example to explain this informational problem is the market for lemon cars. The adverse selection, in effect, arises when products of different quality (e.g. lemon and good cars; junk and good bonds and so on) are sold at a single price because of asymmetric information (inability of the buyer or lender to understand the real quality/risk of the cars/financial product or borrower), so that too much of the low-quality product and too little of the high-quality product are sold. In the market for lemon and good cars, for instance, the equilibrium will result in a market price (due to the inability of the buyer to understand ex ante the quality of the product) a bit higher than lemon cars’ real value and consistently lower than good cars’ real value. Hence, the market equilibrium, in the mid-term, will determine that only lemon cars are sold in the market. This important issue can basically bring a market to the end, justifying mechanisms of signalling as third-party informational role (rating agencies, etc), regulatory interventions or just pre-sale services. See Pindyck and Rubinfeld (2005), \textit{id.}, p. 616; Reinier H. Kraakman, “Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy”, \textit{Journal of Law, Economics and Organization}, Vol. 2, No. 1, Spring 1986.
from the market.

In addition, although the informational asymmetry does not necessarily lead to exploitation of the less informed party, there are situations in which the cost pressure to which financial advisors are increasingly exposed creates incentives for the providers to exploit their superior information to the detriment of their customers. In retail banking, for example, this is not only due to the current financial crisis, but also to other factors such as the fact that the majority of clients do not contribute to profits or are even characterized by a negative profit contribution, and that an average financial advisor in the retail segment have to take care of 850–2,000 clients. Furthermore, according to a study of the consultancy McKinsey and Company, only 13% of a financial advisor’s working time is dedicated to advising and selling tasks, while the remaining 87% is spent on administrative duties. Finally, since under the prevalent pricing model the actual service of advice giving is offered free of charge and then cross-subsidized by provisions and fees resulting from the sale of the products subsequent to the advice giving process (service model; e.g., Kaas and Severidt 2002), advisors are under enormous pressure to sell their products as efficiently as possible.

Interestingly, a corollary of this finding is that increased competition does not eliminate the problem, and may even strengthen the incentive for financial advisors to exploit their customers, due to increased cost pressure. Advisors able to exploit unobservable (hidden) information may have a stronger incentive to recommend products with the highest commissions, or riskier investments, knowing that they will be able to justify any negative result by invoking exogenous, unpredictable shocks.

In this respect, stronger competition policy alone is not likely to lead to any improvement in the quality of financial advice, since financial advisors compete on observable qualities, and normally economise on unobservable ones. Put differently, none of the oft-quoted self-healing properties of consumer markets (screening, signalling, self-selection, guarantees, alignment of interests, reputation-transfer, and reputational constraints) is observable and operational in retail financial advice. Improving the quality of information exchange is not profitable and thus not interesting for the financial service provider.

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244 Stiller 2003.


246 Id.


2.1.1.1 Financial education and customer effort in “shopping around”

As reported by the European Commission in its Communication on Financial Education in 2007, “numerous international surveys have demonstrated consumers’ generally low level of understanding of financial matters and of basic economics”\(^{249}\). The fact that individuals find financial matters difficult to understand, and often overestimate their understanding of these matters, constitutes a key obstacle to their ability to shop around for the best deal, when these opportunities exist. At the same time, the limited understanding of financial issues exposes customers to misleading information by their financial services providers, thus magnifying the scope for, and impact of, unfair commercial practices in this field\(^{250}\).

The effect of the lack of information and financial education on the customers’ side in the retail financial services sector is also combined and enhanced by the limited effort that customers seem to devote to the search for a better deal in this sector. As a matter of fact, many retail financial products (mortgage loans, current accounts, insurance products, etc.) are considered as a necessity, but hardly attract the curiosity of customers (also since they normally exhibit a low degree of differentiation): search costs are perceived as very high by the average customer. This is reflected in empirical analyses that show that customers exhibit a particularly low tendency to switch provider in current accounts, life insurance, etc.\(^{251}\) The issue of habit and practical


\(^{251}\) Especially in some countries, there is ample evidence that consumers exhibit on average limited
convenience in dealing with financial providers is a particular reason for remaining loyal to a given institution. For example, a survey by nVision in 2003 revealed that UK consumers remained loyal to their bank mostly for practical reasons.

In addition, as reported by the Nordic Competition Authorities, “lack of interest seems to be a common feature among bank customers”. The report quotes a survey performed by Berg and Borgeraas252 among retail banking customers, which concluded that two of the reasons for low customer mobility relate to the facts that “customers have an unconsidered relationship with the banking market”, and that “bank affairs are low interest areas”. It seems that many customers do not compare prices and services and have a lack of interest and commitment when it comes to financial services253, because of the excessive cognitive demand that comes along with it254.

Finding # 10
Lack of financial education and limited effort by consumers in shopping around exacerbate the impact of the information asymmetry in the retail financial services sector, leading to low customer switching and limited pressure on providers to improve their quality of service. This, in turn, makes it even more likely that more informed service providers decide to adopt commercial strategies that are detrimental to customers.

2.1.1.2 Information asymmetry, relationship banking and switching costs

The asymmetry of information between providers and customers leads to the emergence of other market effects. For example, the fact that customers face important obstacles in appraising whether their counterpart is behaving correctly and providing a high-quality service also implies that customers that are already involved in a contractual relationship with a financial service provider may be discouraged from switching, as this would imply investing again in familiarising with a new service provider, with limited chance of being able to appraise the reliability of the counterpart


253 See also the interesting analysis provided by Berg, L. (2008), Loyalty, naivety and powerlessness among Norwegian retail bank customers, International Journal of Consumer Studies Vol. 32, n. 3, at 222–232.

before signing and executing a new contract. For this reason, experience and credence qualities may represent a transaction-specific investment for the customer, which makes it very difficult to switch to competing banks (so-called path-dependency or status quo bias)\textsuperscript{255}.

In financial services, the relationship between the provider and the customer is particularly important, mostly due to the trust-based relation that must be created in a situation of informational asymmetry. This also means that customers perceive the relationship as a long-term one, and build their relation with the service provider over time\textsuperscript{256}. This can be qualified as a transaction-specific investment (TSI) as illustrated in the seminal contribution by Oliver Williamson (1975)\textsuperscript{257}. Faced with this “sunk” investment, customers perceive high switching costs: changing provider would indeed mean, at once, losing the previous TSI and having to face a new, equally “sunk” investment in familiarising with the new provider. This effect is particularly strong for investment products, where the fiduciary role of the service provider may be essential for retail investors\textsuperscript{258}. The information and behavioural biases involved can lead to rather high “perceived” switching costs, difficulties in evaluating alternatives, and consequently low price transparency and customer mobility\textsuperscript{259}.

This leads customers to rely on proxies to establish the value of a given investment option – the proxy, in this case, being the advice received by their service provider. For this reason, the so-called “relationship banking” often attracted specific interest in the law and economics literature\textsuperscript{260}. Moreover, as will be explained in the next sections,

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\textsuperscript{255} See supra, note 167 and accompanying text.

\textsuperscript{256} See data on the duration of relationship in this sector, as reported by the European Commission in the Sector Inquiry on Current accounts and related services (2006), cit. The literature on marketing is consistent in indicating the role of trust, satisfaction and average perceived cost (including switching costs) as determinants of loyalty. See, i.a., Raoul Graf, Fabien Durif, Mario Belzile (2008), “Echo Generation”: switching costs and the relational approach in the banking industry, Innovative Marketing Vol. 4, Issue 1, at 77-86; and Graf, R., Perrien, J. (2005), “The Role of Trust and Satisfaction in a Relationship: the Case of High Tech Firms and Banks”, Proceedings of the 34th EMAC Conference, Milan, Italy.


\textsuperscript{259} In this respect, the retail financial services sector can be said to differ noticeably from other economic sectors. For example, in telecommunications or energy sectors consumers are less likely to suffer from an information asymmetry, provided that they have visibility of the quality of service and relative price of the offer. At the same time, the elements of “trust”, “transaction specific investments” and “bounded rationality” are much less important in these fields. Finally, especially in the telecommunications sector consumers are more likely to shop around for better offers.

rational ignorance is also one of the reasons why aggressive commercial practices and unsolicited offers can have very similar effects to contractual tying: accordingly, merely banning tying may lead to the emergence of other practices which 
\textit{de facto} reach the same result by “inducing”, rather than “forcing” consumers to buy additional products. The turmoil induced by the financial and economic crisis has tended to result in pronounced disturbance and perturbation of the markets. The increased volatility of financial indicators and proxies progressively blurred the information available\textsuperscript{261}. Therefore, the current context tends to amplify the specific characteristic of information asymmetry between providers and customers in the retail financial market.

More in detail, the provider-customer relationship can be described by two main dimensions, according to the literature: the “depth” of the relationship, stemming from the “off-contract” entrepreneur-banker relationship, and the thickness, defined as the information conveyed to the bank through the multiple financial contracts and services. In particular, the thickness of the provider-customer relationship offers customers a range of potential advantages, but is also associated with the possibility, for the more informed provider, to capture rents in the relationship by exploiting in hold-up behaviour and false representation of both market and contractual conditions. In many case, this relationship is strengthened by personal feelings with the person who represents the provider.

\textbf{Finding # 11}

The experiential, long-term and risky nature of provider-customer relationships in many retail financial markets leads to high switching costs for customers, due to sunk investments associated with the contractual relationship. This, in turn, leaves customers in a weak position vis-à-vis their counterparts.

The more complex, deeper and thicker the relationship between providers and customers, the higher the probability that providers can engage in exploitative behaviour, especially when customers cannot observe the quality of the service provided to them in the long run.


\textsuperscript{261} As recently observed by the OFT in its consultation document on the financial services strategy, adopted in April 2009, The financial crisis may change consumers’ behaviour in many ways: (i) Prior to the crisis, competition in financial services took place on parameters such as price, rates offered, product range, quality and brand. Consumers may now place greater weight on factors such as security and soundness of financial institution. (ii) Customer behaviour based on these parameters may result in reinforcing the existing status-quo and reduced opportunities for small innovative players to enter the market. (iii) Consumer preferences may also change with regard to the type of products they seek. Consumers may move away from long-term savings and investment products in favour of shorter-term, more liquid, products. See the OFT document, 1077con, \textit{cit.} at B27-B29.
2.1.2 Behavioural economics and decision-making biases

In addition to market and product attributes, consumer choice may also be distorted due to purely structural factors, which do depend neither on the type of relationship, nor on the abusive behaviour of banks, but pertain to the sphere of bounded rationality and risk aversion. Where these cognitive biases are observed, markets may fail irrespectively of the behaviour of providers. Faced with these problems, legislators have the specific role of devising, where possible, rules that minimise the impact of cognitive biases on consumer choice. The behavioural law and economics literature, coupled with modern neuroeconomics, is advancing in the direction of identifying ways of “debiasing through law”\(^\text{262}\). This stream of literature is particularly relevant for the financial services sector, as testified by the emphasis put on financial services by recent reports both at OECD level and by the UK OFT\(^\text{263}\).

People are not always “rational” in the sense that economists suppose. But it does not follow that people’s behavior is unpredictable, systematically irrational, random, rule-free, or elusive to social scientists.

(Cass R. Sunstein 2000, p. 1)

Financial services are natural candidates for a policy intervention in this respect, given that customer decisions in these markets often involve risk, uncertainty and ambiguity\(^\text{264}\). Important behavioural biases that surface in particular in retail financial services include choice/information overloads, endowment biases, self-serving biases, overconfidence, framing effects, difficulty in handling uncertainty and risk, and misevaluation of future benefits and costs\(^\text{265}\). In the UK, for example, the Financial Services Authority (FSA) has analysed cognitive biases as one element of “financial capability” than can explain failures in decisions over uncertain investment options\(^\text{266}\). The OFT has proceeded along similar lines in its market study on personal current

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\(^{265}\) See also Ulen and Korobkin (2006), cit.; Jolls (2007), cit.

accounts. The OECD, instead, identified a list of potential effects that are most likely to emerge when consumers deal with risky or ambiguous situations. We list these biases in two categories: biases affecting judgement and biases conditioning the decision-making process.

On the judgement side, we can identify a list of potential biases:

- **Choice/information overload bias**: economic models suggest that the benefits from extra choice and information are unbounded. Even the theory of “bounded rationality” does not suggest that extra choice and information is detrimental. Market research however, in products as diverse as jams and retirement savings, suggests that past a point, when provided with more choice and information, we either walk away from markets, choosing not to choose, or we choose randomly.

- **Self-serving bias** affects judgment when individuals face a matter with room for disagreement. They will tend to interpret information in a direction serving their own interests. This is a judgment error, a distortion of people’s perception, for instance, of what is fair. This self-serving assessment can impede negotiations and it might affect people’s perception of social norms, in particular what is “moral” in the market; for instance, the credit “immorality” in subprime (irresponsible) borrowing.

- **Anchoring and adjustment biases**: prospect theory (theory violating the axiom of context-independence) also characterizes judgment behaviours; for

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267 Office of Fair Trading, *Personal Current Accounts in the UK*, Market Study, July 2008, available at [http://www.ofot.gov.uk/advice_and_resources/publications/reports/financial/](http://www.ofot.gov.uk/advice_and_resources/publications/reports/financial/). The OFT in particular looked at six factors: (i) Perceived behavioural control: People’s perceptions of their behavioural control of current account switching were high overall; (ii) Temporal myopia: People’s discounting of future events was not related to switching behaviour. (iii) Overconfidence: People were overconfident about the likelihood that they would encounter charges. (iv) Loss aversion: Concern about losses during switching was slightly lower for switchers, but the overall level of concern was not misplaced. (v) Cognitive engagement: The overall level of cognitive engagement was low: People do not spend much time or effort thinking about their current account. (vi) Fairness: Overall, charges were not perceived as unfair, though those who were charged rated charges less favourably than those who were not charged. Increased awareness of charges and warnings about charges were associated with a smaller difference in fairness ratings between those charged and those not charged.


instance, these biases shape the probabilistic assessment because people frequently fail to "adjust" their assessment from pre-existing cognitive anchors or reference points. There are two effects violating the assumption of context independence: the compromise and the contrast effect (Kelman et al. in Sunstein 2000). The former implies that the relative ranking of two options depends on the presence or absence of other options; the latter effect, by contrast, implies that the same option is evaluated more favourably in case there are similar but more inferior options than in the absence of such options. In addition,

**Overconfidence bias**: people tend to overestimate (to be overconfident about) the probability of an outcome if an example of the event has recently occurred (linked to the prospect theory and the precedent behaviour). Therefore, consumers are generally overconfident in their abilities and in their future fortunes. For example, many people invest, believing that they can beat the stock market, or they underestimate the risk that illness or unemployment may cause difficulty in repaying a loan. Again, this bias is important in financial services.

**Optimism bias**: it involves the belief that good/bad things are more/less likely than average to happen to us. This bias is strictly linked with the self-interest and overconfidence bias above. The borrower, for instance, is affected by this bias especially when she has to consider a deferred-costs transaction like a mortgage contract. Consumers change current consumption with future consumption, relying on a belief that the income in the following period will be higher. There is the perception, due to a mis-evaluation of benefits and costs (hyperbolic discounting myopia), that it will be more likely that she will receive a higher income in the next period. Consumers do not rationally weigh up present against future benefits and costs; rather they put too much weight on the immediate. This bias, in addition, is manifest in outcomes such as low retirement savings in the absence of compulsion.

**Hindsight bias** is the tendency of actors to overlook the ex ante prediction that they made concerning with the likelihood of an event after learning that it actually occurred. This bias has particular effects in tort liability.

On the decision-making process, instead, other biases affect its rational well-functioning:

**Loss aversion bias**: is one of the biases defined as corollary to the prospect theory and it is one of the two biases related to the reference point and framing

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effects. With this bias, an individual will value a decision differently if it is specified in losses instead of gains. In particular, if a decision is perceived as “losses” (or “gains”), relatively to a reference point, the same individuals will be risk-seeking (or risk-adverse). Consumers are influenced not only by the objective information provided by suppliers, but also by the “frame” of that information. For example, a claim “92% fat free” elicits a different response than “8% fat.” The frame in which choices are considered influences consumer’s perceptions of the consequences of uncertain outcomes. When gambles (such as insurance choices) are considered in isolation, consumers tend to be irrationally risk averse. When consumers consider themselves to be in a loss situation (such as becoming heavily overcommitted on a credit card) they tend to behave recklessly. Furthermore, consumers often have difficulty in thinking rationally about possible outcomes with very low probability. Therefore, they experience relevant difficulties in handling uncertainty and risk.

**Status quo bias:** it is a bias that mixes the reference point framing and the endowment effect. People create a reference point for the sense of ownership defined by the endowment effect. Therefore, they would be less willing to deviate from that status, so they will choose the closer solution. The status quo bias backs behaviours that in contract law do not allow contractual solutions deviating from default rules. This behaviour, then, may lead low and moderate-income borrower to accept very high interest rates and/or unfavourable terms.

**Endowment effect bias**274: is a bias mixing loss aversion and status quo biases. It proves that the invariance assumption of the Coase’s Theorem275 fails to describe the real bargaining process for entitlements allocation. The initial allocation of entitlements matters, due to the endowment effect. Moving from that reference point thus will always include a trade-off. Hence, the irrelevance of legal rules, recalled in some circumstances, is a claim that no longer holds. What one has is valued more than what one might have. Consumers are often reluctant to switch suppliers because of a loyalty, which may be misplaced, to existing suppliers. This is particularly evident in telecommunication and financial services.

All these biases, as described above, are particularly likely in the retail financial services sector. All of them should be taken into account in appraising the likely impact of observed practices. In effect, individuals seem to make systematic errors in risk assessment, for instance, overestimating certain risks that can be vividly recalled, and underestimating others. In more operational terms, the existence of structural cognitive biases can be included in the overall assessment of barriers to customer mobility, as


well as in the overall assessment of the likelihood that providers exploit the risk attitude of their customers by imposing unfair commercial terms. For example, the literature on prospect theory explains that individuals' willingness to pay for a product is systematically lower than the compensation they would require to accept the loss of a product they are already consuming. This, in and of itself, explains part of the hesitance of customers when deciding whether to switch\textsuperscript{276}.

Finally, for what concerns financial advice (both pre- and post-contractual), a very relevant effect to be taken into account is the information overload. For many reasons, as complexity and cognitive biases to assess an array of alternatives, customers with low financial education will suffer from the reception of a huge flow of information\textsuperscript{277}.

Finding # 12

Financial services are characterised by widespread biases on the side of consumers affecting judgement and decision-making processes, such as framing and endowment effects, the mis-evaluation of future benefits and costs as well as difficulties in handling uncertainty and risk due to loss aversion bias and so on and so forth.

In particular, endowment and framing effects lead to high switching costs, as customers prefer a certain contractual relationship to a hypothetical improvement associated with switching. The higher the endowment and framing effect, the lower the customer's willingness to switch provider will be.

2.2 A closer look into switching costs

As explained above, the specific conditions observed in retail financial markets lead to the emergence of limited customer mobility and switching costs\textsuperscript{278}. As will be shown below, the emergence and extent of such costs can be the consequence of practices such as cross-selling and some conditional sales practices. This impact depends \textit{i.a.} on the products and services taken into consideration. In this section, we analyse more in detail the nature of switching costs and their emergence in different sectors.

Switching costs allow the firm to unilaterally increase the price of services and products higher than the rival, since customers are locked-in. The lock-in effect in a mature and oligopolistic market, such as financial services, ignites a competitive mechanism \textit{à la Cournot}\textsuperscript{279}, since few incentives exist to compete on price. In effect, firms should offer a


\textsuperscript{277} See Oehler and Kohler (2009), \textit{Financial Advice Giving and Taking, cit.}, at 103.

\textsuperscript{278} OFT (2009), \textit{cit.}

\textsuperscript{279} The presence of high switching costs artificially supports the perception of product's differentiation
price discount that should be higher than the switching costs, to attract rivals’ customers and induce them to switch and bear the related costs. The final outcome thus is potentially more harmful than the monopolistic outcome due to the consumer lock-in effect, which will hamper customers’ freedom choice and mobility and so even competition.

In effect, the artificial final equilibrium can strongly deter market entry, since an oligopolistic equilibrium at market level prevails, while at firm-consumer level the lock-in effect may induce firms to charge a supra-competitive price (up to the monopolistic price)\(^{280}\). In addition, in a growing market with switching costs, firms are willing to price very low in order to attract new customers and then to reap benefits once locked-in, increasing market price (“bargain then rip-off”\(^{281}\)).

In the retail financial services sector, the following costs are likely to impede switching by consumers:

- **Transaction costs**, e.g. documentation, time, fees, search costs, other information costs, learning costs, etc.;
- **“Exit” costs**, due to, *i.a.* loyalty programs, early repayment penalties (especially in the case of mortgages), etc.;
- **Uncertainty costs**, especially in financial services, since the quality or suitability of a product can only be observable after purchase (experience attributes), or can never be fully observed by the customer (credence attributes)\(^{282}\);
- **Psychological costs**, mainly in case of goods with high significant credence attributes ("mutual trust"), *e.g.* investment advices, life insurance, etc.\(^{283}\)

There is ample evidence that customers in the retail financial services sector do not switch provider very often. For example, Pomp *et al.* (2005) report the results of a survey run by the Dutch Consumentenbond in 2002 on the switching behaviour of consumers in a number of different markets (1,091 respondents). As illustrated in the

(by old customers) in the Cournot’s model, although the outstanding assumption of product homogeneity has special validity for new customers (not locked-in yet). See Cournot (1838), *cit.;* Motta (2004), *cit.,* p. 556.

\(^{280}\) This likely market outcome can be only seen as result of no-collusive firms’ behaviours. In fact, markets with high switching costs undermine the severity of any retaliation for deviation from a collusive agreement (punishment very costly). The impact of switching costs on a collusive agreement is indefinable; see OFT (2003), *id.,* p. 4.

\(^{281}\) See Armstrong, OFT (2008), *id.,* p.28.

\(^{282}\) See *supra*, note 168 and accompanying text.

figures below, characteristics of the financial services included in the sample appear quite clearly. Very few customers in mortgage, current account and life insurance were planning to switch (Figure 5); and very few were aware of the existence of alternatives (Figure 6), especially for current and savings accounts.

**Figure 20 – Percentage of customers that plan to switch**

![Percentage of customers that plan to switch](chart)

**Source:** Pomp et al. (2005)

**Figure 21 – Customers that are aware of the possibility of choice**

![Customers that are aware of the possibility of choice](chart)

**Source:** Pomp et al. (2005)

The results above are complemented by other surveys regarding the length of banking relationship. As reported by a recent study of the Nordic Competition Authorities, in Norway there is evidence that 85% of SMEs have had the same principal bank for three years or more. Two thirds of the SMEs have had the same principal bank for six years or more. A 2006 survey concluded that 63% of consumers have been loyal to their bank for
more than 10 years. Only 5% have switched bank during the last year. In countries with a not so developed banking system, as Hungary, only 16% of the customers have ever switched banks. In UK the estimated annual switching rate is 4-6%, and in France it is roughly 5%.

In addition, a Eurobarometer Flash was published in January 2009 based on a survey carried out in 2008 by the Gallup Organization upon the request of the European Commission on Consumers’ views on switching service providers in a number of sectors. Switching banking services was found to be difficult by 43% of those who did not want to stay with their current product or provider. The survey also found eloquent results as regard to the consumers’ perception of the comparability of offers, as shown in the figures below. In this respect, retail financial services dominate all other services as regards the difficulty of comparing alternative offers. European consumers find it quite difficult to compare offers in services such as savings or investments, mortgage loans, long term loans, and even current accounts. A breakdown between vulnerable and non-vulnerable consumers highlights that this problem is widespread, not confined to a specific category or group.

Figure 22 – Comparability of offers

The results of the recent surveys are particularly interesting for the purposes of our report, as they suggest that European citizens consider it to be very difficult to compare alternative offers. Accordingly, they do not switch provider very often, nor seem

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particularly eager to switch. Looking more closely at the reasons why customers do not switch, we may identify very interesting findings. For example:

- Compared to other services, consumers consider that the cost and effort required in switching is too large for all retail financial services – a “hassle” factor that seems stronger than in all other surveyed sectors.

- For mortgages and long term loans, a relatively high number of consumers responded that “their contract makes switching difficult”. This suggests that contract terms may include penalties for early contract termination or rule it out entirely.

- In the case of long-term loans, a relatively high proportion of consumers declared that they did not know they could switch.

- The second most frequently cited reason, especially for savings and investment services, is “other”.

**Finding # 13**

In the retail financial services sector, switching is made difficult by the existence of transaction costs, compatibility costs, learning costs, contractual costs, informational costs, uncertainty costs and psychological costs.

Empirical evidence suggests that consumers in the retail financial services sector are particularly unwilling to switch providers, also since they consider it very difficult to compare alternative offers. In particular, compared to other services, consumers consider that the cost and effort required in switching is too large; for mortgages and long term loans, many consumers considered that “their contract makes switching difficult”, and some even declared that they did not know they could switch.

### 2.3 Potentially unfair commercial practices in the retail financial services sector

In the financial services sector, also due to the particular features of the provider-customer relationship and the limited information often exhibited by customers, the practices under scrutiny could end up being detrimental to consumers even when they are not applied by a dominant firm. Under a consumer policy perspective, it is not the exclusionary impact of the practices, but rather its exploitative nature, that determines the unfairness of the conduct.

In this section, we analyse the potential impact of cross-selling practices (including tying, pure and mixed bundling, and preferential or exclusive agreements); conditional sales practices (such as single-product rebates or the obligation to have the salary paid into the current account as a condition to access a mortgage loan); and aggressive
commercial practices (such as unsolicited offers, pressure/inertia selling, churning and steering) in the retail financial services sector.

### 2.3.1 Cross-selling practices

In this group of practices, we have included tying, pure and mixed bundling, and preferential or exclusive agreements. The potential for these practices to prove detrimental to customers is related to a number of factors listed above. Below, we analyse tying and pure bundling separately from mixed bundling and preferential/exclusive agreements.

#### 2.3.1.1 Tying and pure bundling

As already explained in Section 1 of this paper, tying occurs when two or more products are sold together in a package and at least one of these products is not sold separately. Pure bundling occurs when none of the package components is available separately, and the components are offered in fixed proportions\(^{286}\).

In the economics literature, the most significant negative effects that may be associated with tying from the viewpoint of consumer policy – *i.e.*, independently of the degree of market power of the financial service provider – are the following:

- **Tying and pure bundling can lead to higher switching costs and lower customer mobility.** Since tying forces customers to purchase all the tied products from the same provider, when these products are durable goods or services customers will face an increased cost of switching to an alternative provider, since they would lose the products they have bought from that provider altogether, and would need to renegotiate the purchase of all the tied product with a different provider. Customers may thus be reluctant to move to competing providers: this may reduce customer mobility and distort customer choice.

  This effect depends also on what products or services are included in the bundle. For example, when products have different durations, the customer may be reluctant to switch to an alternative provider of a product with a shorter duration, even if this would be easy absent the tying or pure bundling practice. The lifespan of the contractual relationship thus tends to become equal to that of the product or service with the longest duration. For this reason, products such as mortgage loans are often used as “gateway” products by service providers wishing to retain their customers through cross-selling strategies.

  Finally, the impact of tying and pure bundling on switching costs may depend on

\(^{286}\) See Section 1.1.1.1 above.
the thickness of the contractual relationship. As observed above, once the customer has invested in a relationship with a personal banker or financial advisor, he or she may find it beneficial to enter into multiple contracts and services with the same provider: at the same time, this also means that switching would be more complicated, as it would entail losing the investment associated with building a relationship with the service provider, and having to bear the additional cost of searching for an alternative one, and testing over time the quality of the new service provider.

These effects have various consequences on customers. On the one hand, tying products with different duration may lead to customer lock-in, which may be detrimental to end customers without providing potentially countervailing efficiencies; on the other hand, the “thickness” of a relationship exhibits both beneficial and detrimental effects to customers, although it may expose the latter to exploitative behaviour of their counterparts during the course of the relationship.

It could be objected that, if the market is sufficiently competitive and all the products in the bundle can be offered by other firms, customers may find it profitable to switch even if they have bought a large bundle of goods. However, beyond offering a better deal to customers, these competitors would have to compensate them for the sunk investment they have borne to enter the current contractual relationship, as well as for the risk associated with entering a new contract or set of contracts. This can represent an important obstacle to customer mobility in the market.

- **Tying can reduce price transparency and the comparability of offers.** Tying practices make it difficult for customers to single out the price they pay for each product included in the bundled offer. Especially when competitors do not offer exactly the same bundle of products, customers will find it difficult to compare the price they are currently paying for the bundled products with alternative offers by alternative providers. This, in turn, can distort customer choice and lead to reduced customer mobility.

The economics of price comparability has shown interesting developments in the past few years, especially as behavioural economics is increasingly considered to play a role in devising consumer protection rules. In particular, Joshua Gans (2005) elaborated on the concept of “confusopoly” by referring to the existence of competing providers with offers that are structured so differently that it is impossible for an average consumer to compare them287.

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At the same time, reducing price transparency can help financial service providers in introducing cross-subsidies between different products, in particular in the case of add-on contracts: for example, sellers may entice customers to buy a particular product through a low “introductory” price, knowing that they will be able to sell a number of additional products once the customer has entered the relationship. Sellers wishing to compete for only one of the bundled products may have to offer a product below their own cost in order to entice customers to switch.

- **Tying can force customers to purchase unwanted products, or force customers to renounce a better deal by “mixing and matching”**. An interesting example in this respect is that of payment protection insurance (PPI). As will be explained in Section 4 below, some legal systems in the EU27 consider it legitimate for a mortgage lender to force the borrower to also purchases PPI. In this way, the lender may better manage the risk associated with the borrower's default, sickness or death, then possibly leading to lower interest rates on the loan. However, requiring that the borrower purchases PPI is different from forcing the customer to purchase PPI from the same provider. If the borrower could choose to buy PPI elsewhere, then he would be able to shop around to find the best deal. In the UK, this problem has led the OFT to propose new rules for the PPI policies market. In France, the Loi Lagarde will prohibit this cross-selling practice from 1 January 2010.

At the same time, there is widespread consensus that tying can also bring benefits for both providers and consumers. The potential beneficial effects of tying practices include the following:

- **On the supply side, tying can lead to cost savings through economies of scope.** In the financial services sector, tying can allow firms to reduce the costs associated with customer management by using the same information for the provision of more than one service. This also means that a service provider may economise on the investment needed to learn the average riskiness and reliability of their customers, and can apply this information to the provision of more than one service. These savings can be also beneficial to customers, if market conditions lead financial service providers to pass on the efficiencies downstream to their clients in the form of lower prices.

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289 See below, Sections 4.2.1.6 and 4.2.2.14 for details.

290 See infra Section 2.1.1 for a more detailed illustration.
• *Tying can also lead the provider to more efficient pricing*, by avoiding the risk of double marginalisation, and to efficient price discrimination, through the capture of heterogeneous customer preferences by offering a wide range of products in a single package.

• *On the demand side, tying can reduce transaction costs and lead to “portfolio effects” (or “one-stop-shop” effects).* Customers having different needs often prefer to purchase one package of services and products from a single provider, instead of shopping around to find the best deal offered by different providers. This way, they can profit from a reduction in transaction costs, including search, information and negotiation costs. Available empirical evidence shows that consumers prefer to more than one service from a single provider for practical reasons, instead of shopping around for the best deal on all services\(^{291}\).

Overall, it seems clear that tying does not always constitute an unfair practice for customers, as the effects that may be generated by this practice are often beneficial. At the same time, tying can harm consumers and SMEs in the retail financial services sector:

(i) when it involves products of different duration;

(ii) when it forces customers to buy products they did not demand; and

(iii) when it does not produce demand-side efficiencies, or supply-side efficiencies that will be passed-on downstream to the customer in the form of lower prices or better quality.

### 2.3.1.2 Mixed bundling and multi-product rebates

Compared to tying and pure bundling, mixed bundling is normally considered to be less problematic from the standpoint of customer mobility and switching, and accordingly also from the viewpoint of consumer protection. As a matter of fact, mixed bundling entails no coercion of customers, and the purchase of products from separate providers is always possible. In the case of multi-product rebates, customers even benefit from a discount on the overall price, and can freely choose whether to purchase the products individually from different providers, or to obtain the discount and choose one single provider. In addition, regardless of whether customers obtain a financial benefit, purchasing the bundle may benefit them in other ways, *e.g.* through one-stop-shop effects and accordingly a reduction of transaction costs.

From this viewpoint, when there are no competition policy concerns, mixed bundling and multi-product rebates should not create any concerns from a consumer policy perspective either. However, adding a behavioural economics perspective to our

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\(^{291}\) See Section 2.2 for an explanation based on empirical data.
analysis, two additional factors may be taken into account.

- *Does coercion really make a difference?* It may be observed that, given the limited information of consumers and the high switching costs associated with the experiential nature of retail financial services and the need to “shop around”, the effect of mixed bundling may be very similar to that of tying or pure bundling, since customers would be enticed to purchase the package in order not to face the hassle of having to shop around for better deals.

- *Why tie what could be sold through mixed bundling?* Because of the abovementioned characteristics of retail financial services, mixed bundling features the same potential benefits of tying for customers, without entailing coercion. In addition, from a consumer perspective, mixed bundling: (i) preserves the incentive for service providers to pass-on downstream the supply-side efficiencies generated by cross-selling, especially when specialised providers are able to offer comparable services and thus exert competitive pressure on the multi-product provider; and (ii) allows customers to compare the price of standalone products with the price of the bundle, in case the latter is offered at a discount. In a nutshell, mixed bundling is as beneficial as tying and pure bundling for customers, but may have a weaker impact on customer mobility. More specifically, mixed bundling preserves customer choice especially before the contract is concluded, as customers have an incentive to shop around and, if convenient, “mix and match” by purchasing products from different providers. However, mixed bundling can still affect customer mobility once the contract has been concluded.

### 2.3.1.3 Preferential or exclusive agreements

Compared to tying and bundling, preferential and exclusive agreements include: (i) case in which the provider forces the consumer to purchase an additional product from another provider, *e.g.* an affiliated body; and (ii) cases in which the customer spontaneously demands an additional product, and the service provider either offers a better deal conditional upon the choice of a designated provider (preferential agreement), or directly imposes a counterpart (exclusive agreement). In the former case, the rationale that applies is identical to the one we exposed for tying and bundling in the previous two sections, with the difference that the combined product is purchased from a different provider. Below, we focus on the latter case.

In line with the reasoning above, exclusive agreements are more likely than preferential agreements to lead to a reduction of customer mobility, and force customers into a contractual relationship with a provider they have not freely chosen. This, in turn, provides sellers with the possibility to exploit locked-in customers, although the magnitude of this effect is likely to be smaller due to the fact that the product has been spontaneously demanded by the customer.
None of these practices exerts a substantial impact on price transparency, whereas exclusive agreements affect the comparability of offers. At the same time, both types of practices can create supply-side efficiencies for providers, when the financial services involved are complementary. Providers may then be able to exploit economies of scale and scope by dealing with a preferred partner. In the case of preferential agreements, though, the provider has greater incentive to pass on these efficiencies downstream to the end customer, rather than keeping them as extra-profits.

Finding # 14

Tying does not constitute always an unfair practice for customers, as the effects that may be generated by this practice can often be beneficial. At the same time, tying can harm consumers and SMEs in the retail financial services sector especially: (i) when it involves products of different duration; (ii) when it forces customers to buy products they did not want; and (iii) when it does not produce demand-side efficiencies, or supply-side efficiencies that will be passed-on downstream to the customer in the form of lower prices or better quality.

When they create no competition policy concerns, mixed bundling and multi-product rebates create no concern also from a consumer policy perspective. However, adding a behavioural economics perspective to our analysis, two additional factors should be taken into account: (i) given the limited information of consumers and the high switching costs associated with the experiential nature of retail financial services and the need to “shop around”, the effect of mixed bundling may be very similar to that of tying or pure bundling, since customers would be enticed to purchase the package in order not to face the hassle of having to shop around for better deals; (ii) Mixed bundling is as beneficial as tying and pure bundling for customers, but – contrary to the latter practices – has a weaker impact on customer choice.

Exclusive agreements are more likely than preferential agreements to lead to a reduction of customer mobility, and force customers into a contractual relationship with a provider they have not freely chosen. None of these practices exerts a substantial impact on price transparency, whereas exclusive agreements affect the comparability of offers. At the same time, both types of practices can create supply-side efficiencies for providers, when the financial services involved are complementary.

2.3.2 Conditional sale practices

2.3.2.1 Action-conditioned practices

In these types of practices, without compliance with the specific condition, the product is not sold at all. A typical example of this type of practice is the obligation to have the salary paid into the customer’s current account as a condition to obtain a mortgage
loan\textsuperscript{292}. From the standpoint of consumer policy, this practice creates concerns to the extent that it forces customers to undertake specific actions in order to access a given service. This also means that customers will be hampered in their freedom to choose where to have their salary paid, and will have problems in choosing, for example, an alternative personal current account that offers better contractual conditions (\textit{e.g.} a higher interest rate).

At the same time, such a practice can create supply-side efficiencies related to better risk management, since the provider knows that the customer will keep a sufficient amount of money into the current account that is coupled with a mortgage loan. The extent to which these efficiencies could be converted into better contractual conditions for the customer depends on the competitiveness of the markets involved, as well as on the degree of customer lock-in. For example, in the UK the so-called “offset mortgage” and “current account mortgage” offers a number of advantages to borrowers, including lower interest rates and tax advantages (savings will not generate any investment income to be taxed. Instead, less interest will be payable on the mortgage)\textsuperscript{293}.

Against this background, the potential for a conditional sale practice to be considered as unfair to consumers strongly depends on: (i) whether the latter has the possibility of choosing alternative contractual schemes – this includes the possibility, for competitors, to replicate the conditional sale arrangement; and (ii) whether the conditional sale allows better contractual conditions, \textit{i.e.} the efficiencies generated are shared with the customer.

It must also be recalled that conditional sale agreements are probably the only practices, among the ones under scrutiny in this paper that may end up being regularly included in a standard form contract. Other than by antitrust rules, they may thus be captured also by legislation on unfair terms such as the EU Directive on unfair terms in consumer contracts. An example of a conditional sale is the inclusion, in the standard contract terms, of clauses that impose heavy sanctions for the case of failure to perform on the side of the customer. One example is the so called “cross collateralization” clause, or “add-on” clause, which was at hand in the famous US Court of Appeals decision in \textit{Williams v. Walker Thomas Furniture}\textsuperscript{294}. In that case, besides the claim that the clause at


\textsuperscript{293} See FSA, \textit{Lifting the Lid on Financial Services}, 2007. Offset mortgages are defined as those that combine savings with a mortgage to reduce the real value of the loan (offsetting). These mortgages allow customers to benefit from offsetting savings against borrowings but still keep all the elements of finance separate. Current account mortgages go one step further by combining all savings and debts into one account, \textit{i.e.} combining a mortgage with a current account. This effectively acts like a single large overdraft into which salary payments are made and current expenditure deducted.

\textsuperscript{294} Cross-collateralization is a term used when the collateral for one loan is also used as collateral for another loan. If a person has borrowed from the same bank a home loan secured by the house, a car loan secured by the car, and so on, these assets can be used as cross-collaterals for all the loans. If the
hand was unknown to the plaintiff and unconscionable, another important question that arose was whether the cross-collateralization clause was essential for the seller to secure payment; and whether, absent that clause, the plaintiff would not have had any access to the goods purchased, due to excess risk of default. The main problem with the clause was the lack of information and possibility of choice on the side of the customer, not the clause in and of itself.

In summary, conditional sale practices such as the obligation to have the salary paid into the current account or cross-collateralization clauses may be detrimental to customers when they deprive consumers of their freedom to choose alternative products. However, when the practice is replicable by competitors and the “condition” specified in the conditional sale agreement leads to benefits for customers, there is no reason for concern from the standpoint of antitrust or consumer policy.

2.3.2.2 Behaviour-conditioned practices

One example of these practices is banks that charge no credit card fee if the cardholder spends more than a given amount of money every year. We term these practices conditional rebates. The usual nature of a conditional rebate is that the customer is given a rebate if its purchases over a defined reference period exceed a certain threshold, the rebate being granted either on all purchases (retroactive rebates) or only on those made in excess of those required to achieve the threshold (incremental rebates). The loyalty-enhancing impact of these rebate schemes has attracted the attention of competition authorities.

person pays off the car loan and wants to sell the car, the bank may veto the deal because the car is still used to secure the home loan and other loans. Technically, cross-collateralization expires when the borrower has no outstanding loans with the bank. In Williams v. Walker-Thomas Furniture, Walker-Thomas extended credit from 1957 to 1962 to Mrs. Williams for a series of furniture purchases. The contract was written in such a way that no furniture could be paid off until all of it was. When Mrs. Williams defaulted on the contract in 1962, Walker-Thomas tried to repossess all the furniture sold since 1957. The District of Columbia Court of Appeals ruled that the lower court could rule the contract unconscionable and refuse to enforce it, and returned the case to the lower court to decide whether or not the contract was in fact unconscionable. See Korobkin, R. B. (2004), A 'Traditional' and 'Behavioral' Law-and-Economics Analysis of Williams v. Walker-Thomas Furniture Company, UCLA School of Law, Law & Econ. Research Paper No. 03-24 and University of Hawaii Law Review, Vol. 26, p. 441, 2004.

In the case of the obligation to have the salary paid into the current account, the practice does not create antitrust concerns if it is replicable by an as-efficient competitor; in addition, it does not create concerns from a consumer policy perspective if it proves beneficial to the customer. For example, for the UCPD to be applicable, the latter should be detrimental to customers.

See supra, Section 1.1.2.1.

Like cross-selling practices, also these practices are not always to be considered as unfair to customers. On the contrary, some of them – especially rebates – could even be beneficial to end users. However, under certain conditions, they may negatively affect consumer welfare due to the particular characteristics of the market in which they are observed. For example, loyalty schemes in the retail financial services sector have been found to be potentially enhancing complexity, making it even more difficult for customers to compare products, prices and services, and thus leading to “confusopoly”. At the same time, loyalty discount schemes can increase switching costs, since alternative providers must compensate customers for the loss of the discount if to entice them to switch.

**Finding # 15**

Conditional sale practices such as the obligation to have the salary paid into the current account or cross-collateralization clauses may be detrimental to customers only when they deprive them of their freedom to choose alternative products. However, when the practice is replicable by competitors and the “condition” specified in the conditional sale agreement leads to benefits for customers, there is no reason for concern from the standpoint of both antitrust and consumer policy.

Like cross-selling practices, also conditional rebates and loyalty schemes are not always to be considered as unfair to customers, and can often be beneficial to end users. However, they may negatively affect consumer welfare due to the particular characteristics of the market in which they are observed. This is the case, for example, of some loyalty schemes in the retail financial services sector, which may lead to information overload ("confusopoly"). At the same time, loyalty discount schemes can increase switching costs, since alternative providers must compensate customers for the loss of the discount to entice them to switch.

### 2.3.3 Aggressive commercial strategies

As observed above, many features of the financial services sector call for the creation of an *ad hoc* test to assess the potential impact of observed practices. Particular features include, most notably, the informational asymmetry between sellers and customers; the strong element of trust and path-dependency embedded in “relationship finance” (especially for some products such as personal current accounts); the limited interest and awareness of customers in “shopping around” for best deals; the importance of switching costs; and a series of cognitive biases such as choice/information overloads, endowment biases, overconfidence, framing effects, difficulty in handling uncertainty and risk, and misevaluation of future benefits and costs. In effect, these strategies frequently put pressure on consumers also through the use of misleading information or the exploitation of emotional states, to induce the customer to purchase the product or service.
In the universe of retail financial services markets, it is possible to identify some practices not related to specific contractual conditions offered to customers, but to the information flow between the service provider and the customer. In effect, the asymmetric information observed between the seller/intermediary and buyer/investor may induce the more informed party to pursue a set of aggressive commercial practices, potentially “unfair”. In retail financial services, as recalled above, the information asymmetry between parties may raise two potential harmful common problems in retail markets, moral hazard and adverse selection. In this scenario, three aggressive commercial practices can be recognized in retail financial services:

- Unsolicited offers (e.g. so-called “pressure selling” or “inertia selling” of products that were not requested);
- Churning; and
- Steering.

The “unfairness” of these practices is essentially linked to the fiduciary relationship between service provider and the potential buyer/investor. Accordingly these practices are more likely to emerge for those retail financial services that require sophisticated financial advice. The asymmetric flow of information between parties involves a high potential risk of customers’ exploitation and harm, with sliding effects also on market competition (increasing switching costs). One stop-shop effects and such informational problems may lead the buyer/investor to choose a package of products from a single provider and/or with “bad” contractual conditions, instead of choosing their “best deal” across a consistent range of services’ providers.

Lastly, there are many other sector-specific practices, which are not included as general categories of potentially “unfair” practices, since they are related to niches of the broad

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298 The term “pressure selling” is often used in the literature on consumer contracts. The European Commission used this term in a number of occasions, often coupled with misleading marketing. Pressure selling, in the Commission’s definition, includes (i) implying that the consumer cannot leave the shop until they sign a contract; (ii) conducting personal visits to the consumer’s home and ignoring the consumer’s request to leave or not to return; and (iii) demanding payment for products supplied by the trader, but which were not requested by the consumer (inertia selling). Misleading advertising includes practices such as (i) claiming to be a signatory to a code of conduct when the trader is not; and (ii) describing a product as “gratis”, “free”, “without charge” etc. if the consumer has to pay anything other than unavoidable delivery or collection costs. See, i.a., the Press Release “EU law to ban pressure selling: Commission welcomes Council’s common position”, IP/04/1364 of 16 November 2004.

299 A relationship is “fiduciary” when is based on confidence and trust between two or more parties. One party (agent) will act on behalf of another in circumstances in which the other party (principal) has not enough knowledge or means to unilaterally undertake a specific action. The fiduciary relationship exposes a beneficiary/principal to two distinct types of wrongdoing: first, the fiduciary may misappropriate the principal’s asset or some of its value (negligence); and second, the fiduciary may neglect the asset’s management (failure to perform). See Cooter R. and B. J. Freedman, “The Fiduciary Relationship: Its Economic Character and Legal Consequences”, 66 N. Y. U. Law Review, pp. 1045-1075, 1991.
market for financial services. These include “loan flipping”\textsuperscript{300}, “laddering”\textsuperscript{301}, “stuffing”\textsuperscript{302}, “failure to execute”\textsuperscript{303} and other operations more related to the provision of misleading information and the violation of privacy, which are not specific subject of this report or do not have a broad impact on the retail financial services sector.

**Unsolicited Offers**

A product or service offer is unsolicited when customers do not expressly request it and it involves a particular pressure on them to purchase that specific offer\textsuperscript{304}. Hence, this practice may be extremely harmful because, on the one hand, it increases switching costs and affects customers’ freedom of choice; on the other hand, it does not entail any efficiency that can be shared by customers\textsuperscript{305}.

In order to consider an offer “unsolicited”, three aspects should be verified\textsuperscript{306}:

1. Service provider makes persistent and unwanted contact via personal relations or various forms of remote media, whereas
2. The consumer has not expressly requested such services or has given his/her consent to be contacted, unless
3. There is no prior contact between customer and bank on related financial services.

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\textsuperscript{300} In which a lender persuades homeowners to refinance their mortgages repeatedly and in short intervals; see Engel K. C. and P. A. McCoy, “A Tale of Three Markets: The L&E of Predatory Lending”, Texas Law Review, Vol. 80, No. 6, May 2002, p. 1263.

\textsuperscript{301} Banks involved in initial public offers can allocate initial shares to institutional investors, which commit to buy additional share in the secondary market to artificially increase prices, usually attracting retail buyers who are unaware of this private commitment; see Walter I., “Conflicts of Interest and Market Discipline Among Financial Service Firms”, *European Management Journal*, Vol. 22, No. 4, 2004, p. 366.

\textsuperscript{302} Investment firms, which are high exposed with specific firms, can place unwanted securities on account where they have full discretion to reduce their exposure to losses; Walter I. (2004), *id.*, p.365.

\textsuperscript{303} It is potentially used in securities or payments transactions to increase the float conveying important benefits to the firm; Walter I. (2004), *id.*, p. 364.

\textsuperscript{304} Art. 15 EC Dir. 2005/29 on unfair business to consumer commercial practices in the internal market, amending art. 9 EC Dir. 97/7, expressly asks the national legislator “to exempt the consumer from any obligation in the event of unsolicited supplies”.

\textsuperscript{305} “There should be no high-pressure selling, and adequate time should be allowed for the borrower to reflect on the terms and conditions of the loan and to obtain independent advice before signing”, Office of Fair Trading, *Non-Status Lending. Guidelines for Lenders and Brokers*, OFT 192 (revised), November 1997, p. 7, §6.

\textsuperscript{306} See Annex I, N. 26, Unfair Commercial Practice Directive (UCPD), Dir. 2005/29/EC.
For instance, this kind of practice is widespread in the US mortgages market\textsuperscript{307}. It may have an implicit impact on the over-indebtedness of customers (unsolicited credit). However, it can be also employed as a risk management tool in the limited set of cases in which the customer is not able to understand the necessity of a service or product that would enable its counterparty to better manage risk.

**Churning**

“Churning” is a legal term used to define a practice imported from securities regulation. The Securities and Exchange Commission (SEC) defined it as an “excessive buying and selling of securities in your account by your broker, for the purpose of generating commissions and without regard to your investment objectives”\textsuperscript{308}. However, the definition is basically broadened to cover other practices in disparate areas of the financial services sector (not only securities)\textsuperscript{309}. Hence, this practice consists in the excessive use, for example, of the current account or the investment portfolio induced by the financial intermediary (agent) who exploits the informational gap of the other party (principal). It is a misuse of the fiduciary role between intermediary and customer\textsuperscript{310}, due to the lack of monitoring by the latter (e.g. due to information asymmetry)\textsuperscript{311}.

The unnecessary number of services should be assessed in the light of the investor experience and objectives. For instance, the excessive trading or the unnecessary services (in size and frequency) requested to generate extra commissions or fees may potentially affect the suitability of the investment decision or the financial product or service in general\textsuperscript{312}. Therefore, a case of churning can be considered “unfair” whenever

\begin{itemize}
\item \textsuperscript{309} See Walter I. (2004), *id.*, pp. 361-376.
\item \textsuperscript{310} See \textit{ibid.}, p.362.
\item \textsuperscript{311} Churning differs from other practices such as “loan flipping”, since the former is a result of misbehaviour of the agent due to the lack of control of the principal; to the contrary, loan flipping typically occurs when a borrower is unable to meet scheduled payments, or repeatedly consolidates other unsecured debts into a new, home-secured loan at the urging of a lender.
\item \textsuperscript{312} In case of investment and ancillary services, suitability and appropriateness as well as best execution requirements are relevant investor protection rules included in the Markets in Financial Instruments Directive (MiFID) and implemented at national level in all the 27 countries; art. 19 and 21 EC Dir. 2004/39 and Annex 1, Section A and B.
\end{itemize}
it is not justified, e.g. by potential efficiencies for consumers such as quality improvements or better contractual conditions. The trade-off between the economic benefits of the excessive services or products and the extra-fees would certainly be negative in these cases.\textsuperscript{313}

As regards efficiencies, it might be difficult to assess relevant market efficiencies for this widespread practice. The restriction to customer freedom of choice and mobility cannot be easily justified by economies of scale or scope, since through this practice consumers are systematically charged of unwanted commissions compromising their potential choice to use alternative products or services. However, especially in investment decisions, churning (activism) can be a mechanism of signalling of a more informed status for securities professionals\textsuperscript{314}; and potentially increases market liquidity (often considered a “public good”) of financial markets, thus improving their efficiency\textsuperscript{315}. In the long run, though, the performance of “over-active” funds does not hold\textsuperscript{316}.

**Steering**

“Steering” is a practice, especially used in the mortgages market, consisting of stressing the credit risk of a potential borrower to steer him/her to higher cost loans\textsuperscript{317}. The prospect of securing higher fees (and consequently profits) for brokers or intermediaries, who succeed to sell a more expensive financial product or service, may lead to the adoption of this practice. In general, steering can be construed as an intentional misjudgement of the individual’s risk by the financial intermediary, aimed at extracting a rent over a relatively long time period. It may consist of higher interest rates, worse contractual conditions, additional fees, higher closing fees, the imposition of specific requirements (higher collateral provision, etc), etc.

The risks linked to this practice are potentially high, taking into consideration the full discretion of intermediaries in the assessment of the risk and the financial situation of a retail buyer/investor. The fundamental role of this assessment for the transaction’s success needs to be guided by well defined and clearly disclosed criteria of suitability.


\textsuperscript{317} Ernst Keith, Debbie G. Bocian and Wei Li, *Steered Wrong: Brokers, Borrowers and Subprime Loans*, Center for Responsible Lending, [www.responsiblelending.org](http://www.responsiblelending.org), 8 April 2008; “steering incentives” are officially prohibited by the new US Mortgage Reform and Anti-Predatory Lending Act, Sec. 103(c) H.R. 1728, May 2009.
and adequateness – as it is the case for investment services under MiFID - to avoid the widespread diffusion of the practice. However, the enforcement of these criteria may be difficult. In effect, complying with these principles involve relevant investments and the need to modify traditional business models and methods in this field. Therefore, potential failures in the implementation of these principles may affect the market efficiency through the imposition of ineffective burdens.

Finding # 16

Aggressive commercial practices can be seldom justified in terms of supply-side efficiency such as economies of scale and scope, or the protection of “free-rideable” investment. To the contrary, they most often lead to a situation in which financial advisors can exploit their informational advantage to the detriment of customers.

3. Measuring the impact of tying and other potentially unfair practices in the retail financial services sector: a multi-stage test

Tying and other potentially unfair practices represent a wide set of commercial strategies commonly used across industries and also in the retail financial services market. As mentioned above, a case-by-case approach is seemingly the best way to assess whether their potential harmful effect offset the benefits brought to the market and final users, from a competition and consumer policy view. Efficiency reasons can be found in most of the practices previously taken into consideration, with the exception of aggressive commercial practices. There are three main categories in which potential efficiencies can be easily classified:

- **Efficiency reasons related to the provision of the services.** In effect, cross-selling strategies are so widespread because they potentially increase the demand reducing the variability of reservation prices, thereby favouring economies of scale and scope. In other cases, as tying and multi-product rebates, these practices seemingly reduce transaction costs and may avoid double marginalization (with complementary products and prices set independently). Finally, some of these strategies can protect “free-rideable” investments (as pre-sale services) or transaction-related investments which create a hold-up problem.

- **Efficiency reasons related to the consumer welfare.** Notably, consumers can potentially enjoy, at least in the short run, several efficiencies which are mostly concentrated in tying and multi-product rebates. Price reduction is a common benefit for consumers in all of the practices mentioned above, while transaction costs’ reductions and quality improvements are further efficiency reasons linked to tying and multi-product rebates.
• **Efficiency reasons related to the total welfare**\(^{318}\). Tying (and multi-product rebates), conditional rebates and loyalty rebates might represent devices respectively enacting first-degree, second-degree and third-degree price discrimination strategies. In effect, whether “perfectly” enforced these strategies can increase the total welfare for the whole society. However, distributional concerns may arise from the adoption of specific cross-selling strategies. For instance, the "leverage effect" may involve - as previously described (Section 2.1.1.1) – distributional concerns since the supplier can potentially extract the entire surplus enjoyed by consumers, even though the practice increases the total welfare.

Then, these practices may impact on switching costs, price comparability and customers’ freedom of choice (see table below). We try to classify the reasons why commercial practices may end up being unfair to customers in the retail financial services sector, and whether competition law and consumer protection law can effectively address these situations, once assessed on which aspects the practices have impacted the most.

Competition law (Article 82 of the EC Treaty) can capture most of the practices under scrutiny, and in particular tying and bundling, exclusive dealing arrangements, conditional and loyalty rebates, to the extent that they lead to anti-competitive foreclosure of competitors. The economic literature on tying and bundling uses a case-by-case approach to analyze these practices because the anti-competitiveness of the practice is strongly linked to market and product settings in which the strategy is enacted. Aggressive commercial practices in which a dominant firm engage could, in principle, be construed as exploitative abuses, although the case law under Article 82(a) EC Treaty never referred to practices such as unsolicited offers, churning and steering. The need to refer to clearly specified contract terms practiced by a dominant firm makes Article 82(a) very difficult to apply systematically and fully effectively to these practices.

Our analysis also reveals that there are many instances in which an unfair commercial practice may not be captured by antitrust laws. This is mostly because Article 82 ECT requires that the undertaking that engages in the practice holds a dominant position in at least one of the relevant markets involved. In all other cases, the practice does not lead to anti-competitive foreclosure, abusive discrimination or exploitation as defined in Community competition law, and as such is not relevant for the application of Article 82.

Many features of the financial services sector call for the development of an *ad hoc test* to assess the potential impact of observed practices. Particular features include, most notably, the informational asymmetry between sellers and customers; the strong

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\(^{318}\) Such efficiencies refer to practices that increase the total welfare for the society, namely the sum of consumers and suppliers’ surplus. However, these efficiencies do not address any concerns on the redistribution of this increased surplus between suppliers and consumers.
element of trust and path-dependency embedded in “relationship banking” (especially for some products such as personal current accounts); the limited interest and awareness of customers in “shopping around” for best deals; the importance of switching costs; and a series of cognitive biases such as choice/information overloads, endowment biases, overconfidence, framing effects, difficulty in handling uncertainty and risk, and misevaluation of future benefits and costs. In effect, these strategies frequently put pressure on consumers also through the use of misleading information or the exploitation of emotional states, to induce the customer to purchase the product or service.

Some practices may be detrimental to consumers since they reduce customer mobility by increasing switching costs, even if they are not relevant under a competition policy perspective. The impact on switching costs depends on a number of factors, including the type of “gateway” products/services involved; the number and type of bundled services offered; the “exit cost” involved; the existence of switching facilities; and of course the characteristic of the demand, especially as regard the customer’s preference to stable relationships. Certainly, practices such as tying and pure bundling and conditional sales increase switching costs for customers, thus reducing their mobility.

Some practices can harm consumers by reducing price transparency and the comparability of offers. Even practices that do not directly increase the cost of exit from an existing contract may reduce customer mobility. Mixed bundling, conditional and loyalty rebates and other practices related to “introductory” or “acquisition” pricing have this potential, as they may lead to a final outcome in which customers have difficulties in singling out the individual price of products they have purchased, and/or fail to fully calculate the price of alternative offers on the market.

Other practices do not affect directly switching costs or price transparency, but can prove unfair to customers as they result from a strategic behaviour of the financial advisor. This is the case of aggressive sales practices such as pressure and inertia selling, churning and steering, in which the financial advisor exploits his superior information and capitalises on the trust-based relationship with the customer, which characterises most retail financial services (especially mortgage, insurance and investment services).
## Table 2 – Main economic impacts of the practices under scrutiny

<table>
<thead>
<tr>
<th>Practices</th>
<th>Cross-selling</th>
<th>Conditional sale</th>
<th>Aggressive commercial practices</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tying and pure bundling</td>
<td>Mixed bundling and multi-product rebates</td>
<td>Preferential or exclusive agreements</td>
</tr>
<tr>
<td>Switching costs</td>
<td>Strong increase</td>
<td>Increase</td>
<td>Strong increase</td>
</tr>
<tr>
<td></td>
<td>Potential reduction of customer mobility</td>
<td>Customers still have the chance to “mix and match” in the pre-contractual phase</td>
<td>Only for exclusive dealing arrangements</td>
</tr>
<tr>
<td>Price comparability</td>
<td>Lower</td>
<td>Preserved</td>
<td>Preserved</td>
</tr>
<tr>
<td></td>
<td>Customers cannot easily single out the price/conditions of individual products</td>
<td>Customers still have the chance to observe individual prices/conditions</td>
<td>Customers still have the chance to observe individual prices/conditions</td>
</tr>
<tr>
<td>Customer freedom of choice</td>
<td>Reduced choice</td>
<td>Preserved</td>
<td>Reduced choice</td>
</tr>
<tr>
<td></td>
<td>May imply coercion of customers (mostly in non-competitive markets)</td>
<td>Customers still have the chance to “mix and match”</td>
<td>Only in the case of exclusive agreements</td>
</tr>
<tr>
<td>Supply-side efficiencies</td>
<td>Potentially high</td>
<td>Potentially high</td>
<td>Moderate</td>
</tr>
<tr>
<td></td>
<td>- Economies of scale/scope</td>
<td>- Economics of scale/scope</td>
<td>- Better risk management</td>
</tr>
<tr>
<td></td>
<td>- Reduction of inefficiencies</td>
<td>- Reduction of inefficiencies</td>
<td>- Better risk management</td>
</tr>
<tr>
<td></td>
<td>- Better risk management</td>
<td>- Better risk management</td>
<td>- No double marginalization</td>
</tr>
<tr>
<td></td>
<td>- No double marginalization</td>
<td>- First-degree price differentiation</td>
<td>- First-degree price differentiation</td>
</tr>
<tr>
<td>Demand-side efficiencies</td>
<td>Potentially high</td>
<td>Potentially high</td>
<td>Moderate</td>
</tr>
<tr>
<td></td>
<td>- Lower transaction costs</td>
<td>- Lower transaction costs</td>
<td>- Lower transaction costs (“current account mortgage”)</td>
</tr>
<tr>
<td></td>
<td>- Lower price or better conditions</td>
<td>- Lower price or better conditions</td>
<td>- Better contract conditions</td>
</tr>
<tr>
<td></td>
<td>- Quality improvements</td>
<td>- Quality improvements</td>
<td>- Quality improvements</td>
</tr>
</tbody>
</table>
Figure 23

A Multi-stage test (author’s elaboration)

### Antitrust Test

**Screen 1**
Identification of Gateway products
- Gateway Products
  - Mortgage loans
  - Current accounts
  - Consumer loans
  - ...

**Screen 2**
Type of practice
- Type of practice
  - Cross-selling Practices:
    -Tyng
    - Building
    - Mixed Bundling
  - Other Unfair Commercial Practices:
    - Conditional Rebates
    - Loyalty Rebates
    - Exclusive Dealing
    - Aggressive Commercial Strategies

**Screen 3**
Antitrust relevance test
- Anti-competitive effect possible?
  - Dominance:
    - Market power
    - Market position (constraints imposed on competitors)
    - Expansion and entry
    - Countervailing buyer power
    - Power to increase price above competition level for a significant period
  - Replicability of the practice
  - Market Structure
    - Network effects
    - Entry barriers
    - Foreclosure effects
    - Marginal costs significant compared to fixed costs
    - Differentiation of secondary products
- Anti-competitive effects > Efficiencies?
  - Anti-competitive Pressures:
    - Concentration
    - Regulatory barriers
  - Pro-competitive Pressures:
    - Low profitability
    - Production-side efficiencies
    - Risk reduction
    - Economies of scale and scope
    - Unbundling
    - Technical Difficulties
  - YES: UNLAWFUL CONDUCT
  - NO: LAWFUL CONDUCT

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### Customer Impact Test

**Screen 1**
Identification of Gateway products
- Gateway Products
  - Mortgage loans
  - Current accounts
  - Consumer loans
  - ...

**Screen 2**
Type of practice
- Type of practice
  - Cross-selling Practices:
    - Tyng
    - Building
    - Mixed Bundling
  - Other Unfair Commercial Practices:
    - Conditional Rebates
    - Loyalty Rebates
    - Exclusive Dealing
    - Aggressive Commercial Strategies

**Screen 3**
Customer impact relevance test
- Customer mobility and choice
  - Efficiencies > Harms?
    - Efficiencies:
      - Direct impact
      - Convenience (one-stop-shop effect)
      - Financial Advantage
      - Indirect Impact (passing-on)
    - Harms:
      - Lack of Transparency
      - Switching Costs
      - Contractual Costs (duration...)
      - Psychological Costs (relationship thickness)
      - Learning/Informational Costs (Products’ Complexity)
      - Coercion Factor
  - YES: FAIR CONDUCT
  - NO: UNFAIR CONDUCT
In order to assess whether the practices empirically observed are likely to be anti-competitive or unfair from a consumer policy’s point of view, we designed a multi-stage test based on three different level of analysis. The logical steps of the test are graphically showed in the figure above. In particular, in the “preliminary test” stage we identify and score the type of gateway product and the type of practice associated with that product. We then look at the type of practice, as for different gateway products, the same type of practice is likely to lead to different results. For example, a mixed bundling solution of mortgage loans with another product may have a different impact than tying it. In fact, having different combinations of gateway products and practices can help us later in the test, e.g. by evaluating the production and demand-side efficiencies associated with each specific practice observed.

In the “antitrust impact test”, we check whether the anti-competitive effect is possible – this depends on whether the firm is dominant and whether the practice is likely to lead to anti-competitive foreclosure; then, following the Commission’ 2008 Guidance paper on exclusionary abuses under Article 82 of the EC Treaty, we ask whether the practice features redeeming efficiencies, which are likely to be shared with customers. An overall balance of harmful effects and efficiencies leads to determining whether the conduct is likely to be found anti-competitive, and thus unlawful.

In the “customer impact test”, the steps are different, and mirror to the extent possible the unfairness test of the EU Unfair Commercial Practices Directive (UCPD). We then ask whether the practice is likely to reduce customer mobility and choice; and whether it is objectively justified. This latter test includes an assessment of demand-side efficiencies generated by the practice. If the practice overall is found to be beneficial for consumers, we consider it to be lawful. Practices that restrict customer choice and mobility without producing efficiencies for consumers are considered to be unfair, if not objectively justified.

We have common stages in assessing consumer impact and antitrust effects, as described below.

- In screen 1, we define the type of gateway product we are going to investigate. A product is defined as gateway or platform if there is a relevant likelihood that practices involving this product may lead to customer lock-in and reduced mobility. Many financial products and services may be used as “gateway” or “hook” for end customers (e.g. current accounts, mortgage, life insurance, etc).

- Second, in screen 2 we look at the type of practice. For different gateway products, the same type of practice is likely to lead to different results. For example, bundling mortgage loans with another product may have a different impact than tying it; and of course some potentially unfair practices do not even require combined sales. As a matter of fact, having different combinations of gateway products and practices can help us in the test, e.g. by evaluating the production and demand-side efficiencies associated with each specific practice observed.
In the antitrust assessment of the practice (top areas in the graph), we identified the following steps: (i) we check whether the anti-competitive effect is possible – this depends on whether the firm is dominant and whether the practice is likely to lead to anti-competitive foreclosure; (ii) then, following the Commission’s 2008 Guidance paper on exclusionary abuses under Article 82, we ask whether the practice features redeeming efficiencies, which are likely to be shared with customers.

A trade-off between harmful effects and efficiencies will determine whether the conduct is likely to be found anti-competitive, and thus unlawful.

In the customer impact test, the steps are different, and mirror to the extent possible the unfairness test of the UCPD. In our test, we consider the likelihood that the practice reduces customer mobility and choice. In such cases, the results of the test may provide an indication of whether a practice is likely to materially distort the economic behaviour of an average consumer, as required under the UCPD test, and whether the practice is objectively justified. This latter test includes an assessment of demand-side efficiencies generated by the practice (see paragraphs above). If the practice overall is found to be beneficial for consumers, we consider it to be lawful. Practices that restrict customer choice and mobility without producing efficiencies for consumers are considered to be potentially unfair, since they cannot be justified by the existence of efficiencies. Compared to the unfairness test of the UCPD, it was not possible for us to perfectly mirror the extent to which the practice is contrary to professional diligence: this assessment is normally performed by the judge on an ex post basis, and referred to an individual practice under scrutiny. In our case, we must rely on the qualitative interpretation of the results of our test to infer whether the practice can be considered in line with, or contrary to, professional diligence.

**Conclusions**

The paper firstly described the rationales for applying both antitrust and consumer protection legislation to practices widely adopted in the retail financial services area, *i.e.* tying, bundling and other diffused commercial practices. The first part explored the main findings of the legal and economic theory as regards the applicability of antitrust rules to the practices at hand and main policy findings. The second section, instead, illustrates the law and economics of tying and other unfair commercial practices from a consumer policy perspective. This paper shows new empirical data on switching costs and consumer behaviours in retail financial services and other sectors. Finally, the last part designed a test for the assessment of these practices under the umbrella of the competition and consumer policy. We then draw conclusions on the potential impact of the practices under scrutiny on consumer welfare.

From a competition policy view, we can identify several conclusions, looking at the potential application of antitrust law. However, there are several practices that do not directly fall under competition law and therefore can only be alleged to have violated
competition law with exclusionary or exploitative\textsuperscript{319} abuses if the firm adopting the practice is dominant in one of the market involved.

\begin{itemize}
  \item \textbf{a.} The economic literature on tying and bundling does not give a definitive answer about the trade-off between costs and benefits borne by society. It suggests a case-by-case approach (rule of reason) to analyze these practices because the anti-competitiveness of the practice is strongly linked to market and product conditions in which the strategy is enacted. High marginal costs and lack of product differentiation may increase the likelihood that tying harms consumers.

  \item \textbf{b.} A \textit{multi-product rebate} may infringe Article 82 if a firm holding a dominant position in at least one of the bundled products and whether competitors cannot replicate the bundle or the single product offer, as the LRAIC test on the whole bundle or single offer shows anticompetitive advantages.

  \item \textbf{c.} \textit{Preferential or exclusivity agreements} may be helpful in presence of “free-rideable” investments\textsuperscript{320} to assure high quality standards in the provision of the final product or economies of scale and scope. In other cases, they may hamper competition and lead to anti-competitive foreclosure especially when competitors are unable to compete for the full supply to customers, also if equally efficient. However, the probability to be prosecuted under Art. 82 ECT is very low.

  \item \textbf{d.} \textit{Conditional rebates} represent a diffused practice that can stimulate competition, economies of scale (efficiency) and provide benefits to consumer. However, these practices can be considered as anti-competitive when they lead to actual foreclosure of rivals, as well as consumer harm in the medium to long run, due to loyalty-inducing effects.

  \item \textbf{e.} The overall impact of \textit{loyalty rebates} may be more difficult to assess as it depends on firms’ market shares, the market’s competitive structure and the characteristics of customers’ demand. Then, incremental rebates have basically a lower harmful impact than conditional-retroactive rebates, which can induce consumers to harmful loyalty.
\end{itemize}

\textsuperscript{319} Article 82 also applies to so-called exploitative abuses by dominant undertakings. However, the case law on unfair contract terms as Article 82 offenses has remained very limited, and confined to IP-related cases such as BRT/SABAM, GEMA II and DSD. In general, Article 82 cannot be considered as a consumer policy tool and specific legislation is more able to capture the problems that arise in consumer transactions.

f. For aggressive commercial practices, the application of Art. 82 is more difficult, as usually there is no dominance by firms enacting these practices or no recognition of the exploitative abuse over consumers as a problem of competition.

More recently, a tendency to expand the reach of antitrust role to capture specific problems of consumer policy has emerged. For example, the UK the Office of Fair Trading (OFT) has examined and taken action in many financial services markets with a dual mandate of competition and consumer policy, through many investigation in several areas. These new initiatives were aimed at pursuing four overarching objectives of competition, choice, fairness and responsibility. Also in other countries, the need to develop a more consumer-oriented competition policy has emerged. For instance, the recent initiative of the US Fair Trade Commission’s report on mortgage disclosures, taking a stance in favour of consumer information.

In the past few years, also important contributions in the literature highlighted the need to reconcile the two separate worlds of antitrust and consumer protection in order to pursue more effectively a good functioning of markets in the interest of consumers. This, in many cases, requires antitrust to take into account consumer policy, which may identify a number of relationships between market conditions and psychological factors, on the one hand, and the contractual weakness of customers in specific retail financial services on the other hand. Therefore, in consumer policy, we may identify a list of potential other aspects that should be taken into consideration when assessing the unfairness of the service or product provided.

a. Information asymmetry. The asymmetry of information that characterises most consumer contracts is particularly evident in retail financial services, and especially in complex and risky transactions such as investment services. This material condition feeds the concepts of bounded rationality and rational ignorance.

b. Decision-making biases (or cognitive biases). Financial services are characterised by widespread biases (or cognitive biases) affecting consumers’ choice, such as framing and endowment effects, the overestimation of future proceeds or the

mis-evaluation of deferred costs, and difficulties in handling uncertainty and risk. In particular, endowment and framing effects (e.g. reference point) lead to high switching costs, as customers prefer a certain contractual relationship to a hypothetical improvement associated with switching.

c. **Experience and credence factors.** The majority of retail financial services exhibit significant experience and credence attributes. Therefore, customers are exposed to exploitative behaviour on the side of providers, as they may not assess the quality of the purchased service or product also after the use (e.g. credence goods). This limited ability put the seller in a more informed position, which may push customers into purchases that are not in their best interest and generate only higher commission fees (e.g. steering and churning practices).

d. **Financial literacy and customers' effort to “shop around”**. Lack of financial literacy and limited effort in shopping around to compare offers exacerbate the impact of the information asymmetry in the retail financial services sector, increasing switching costs and reducing incentives for sellers to improve their quality of service.

e. **Customer switching and mobility.** The long and risky nature of the relationship between customer and the financial services provider may increase switching costs for customers, due to high sunk investments associated with the contractual relationship, as well as psychological and educational factors mentioned above. Therefore, this situation leaves customers in a weak position vis-à-vis their counterparts.

f. **Relationship finance.** The complexity of the relationship and financial products and services increases probability that providers can engage in exploitative behaviours, especially when customers cannot observe the quality of the service provided to them in the long run, due to low financial education and psychological aspects.

Finally, we can draw two main conclusions in relation to the retail financial services market. Firstly, effects of the provision of these services on competition and consumer protection will vary depending on the characteristics of the service/product (or package of services/products) and the market. Secondly, all these factors potentially impact on customer’s (actual or perceived) switching costs, and thus on customer mobility and choice. The provision of financial services to retail investors, therefore, should balance tools of competition and consumer policy, as the impact of anticompetitive and/or unfair practices may harm customers’ mobility, choice and welfare, thereby thwarting the integration of the European internal market.
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