MELBOURNE CENTRE FOR FINANCIAL STUDIES

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Media Release: "Increasing Household Financial Risk – An Increasing Social Risk?"

Professor Kevin Davis, Director of Melbourne Centre for Financial Studies, argues in a forthcoming article for *Dialogue* (a journal of the Australian Academy of Social Sciences) that "while financial deregulation has brought substantial and widespread economic benefits" it has facilitated an increase in the financial risk borne by households. Davis states that "many individuals do not properly understand or appreciate the risks, costs, or rewards associated with the range of financial products available and marketed to them."

Further, he argues that "the persistently high profit rates of financial institutions and incomes of financial advisers raise the question of whether, despite competition in financial markets, many consumers pay too much for the financial products they need (or feel they need) to purchase."

Davis cites a recent Presidential address to the American Finance Association by Professor John Campbell who speculated on the possibility "that the existence of naive households permits an equilibrium … in which confusing financial products generate a cross-subsidy from naive to sophisticated households, and in which no market participant has an incentive to eliminate this cross-subsidy".

Professor Davis advances three main arguments warranting consideration.

1. "Government policies are causing or providing incentives for individuals to take on increased financial risk." In particular, concessional tax treatment of capital gains income accompanied by the allowance of negative gearing gives incentives for socially unproductive financial risk-taking by individuals. Superannuation policy is also contributing indirectly to increased risk taking. Davis is surprised that recent legislation endorsed indirect leverage, and increased risk taking, by self-managed super funds in instalment warrants, and opened the door for an explosion in similar financially engineered products targeted at these funds.
2. The expanding range of complex financial products and services confronting individuals increasingly responsible for managing their personal financial risk sees financially unsophisticated individuals using unsuitable financial products. "The risk is that practices in modern competitive financial markets can, if unchecked, lead to wide-scale sale of unsuitable financial products to retail customers involving significant social and economic costs." Davis illustrates this with examples from the UK and USA.
3. "The gap between the financial knowledge required, and that possessed, by many households for effective involvement in the modern financial system has created substantial unresolved challenges for policy makers who to date have relied upon a tripartite strategy of improving disclosure, education, and advice. Resolving these challenges without excessive regulatory responses which undermine the benefits of competitive financial markets is a key challenge facing Australian (and international) financial regulators". Davis laments that "financial literacy campaigns, a policy priority (also taken up by financial institutions under their social responsibility charters), while laudable, seem unlikely to make substantial inroads in resolving identified problems".

The paper will be published in Dialogue 26, 3/2007 (www.assa.edu.au) and is available at: www.melbournecentre.com.au.

Professor Davis highlights that two sophisticated and well regulated markets have suffered "wide-spread social and economic problems from herd-like shifts of households into innovative financial products which involve substantial risks." In each instance, the 1990s UK Endowment Mortgage "fiasco" and this year's US Sub-prime lending crisis, "inappropriate incentive structures for product sellers, and ability of mortgage originators to transfer resulting risks to others played important roles."

While much of the current focus is on housing affordability for Generations X and Y, Davis also identifies three potential future problems for baby boomers: "Longevity risk", whereby accumulated savings placed in allocated pensions are exhausted before death (because of excessive consumption, poor investment returns, or unexpected longevity); increasingly high proportional administration costs as self-managed superannuation funds in the pension phase decline in size (exacerbated if the "main" trustee becomes incapacitated); and risks from the complexity and irreversibility of contracts used to finance retirement accommodation.

Davis identifies an "agency problem of substantial magnitude" where "financial advisers are increasingly interlinked with the major financial institutions" who provide the financial products used by households. Low net worth individuals are worst off as they cannot afford up front fees for advice. They are also likely to be bearing greater risks from "under-insurance for health, assets and death".

Davis calls for Government and its agencies to consider additional strategies beyond the current triumvirate of approaches of education, advice and disclosure policies.

Among possibilities worthy of consideration is government specification of a default option for some financial products (such as retirement income products) which would require individuals to explicitly choose to opt out into other products. Individuals are biased towards staying with the specified default option, and "may associate the specification of the default option as conveying valuable information to them about products with suitable risk characteristics for their situation."

While wishing to encourage third party ratings of a greater array of financial products, Davis notes current concerns as to the independence of, and value added by, ratings agencies. Exchange listing of more financial products is one possible way of improving liquidity and reducing exit costs for investors and market prices can provide information and improve transparency.

Value would be added by Government if it set about rectifying "the dearth of publicly available, high quality data" in order that researchers and policy–makers are better able to address risks to different sub-groups by age and by income. Reviewing (and possibly redesigning) how household financial risk-taking is biased by taxation policy would also be welcome.

Melbourne Centre for Financial Studies is a partnership between public and private sectors, and between industry and academe. Seed funding was provided by the Victorian Government as part of its Financial Services Strategy. Members of the consortium are Melbourne, Monash and RMIT Universities, and Finsia. They have joined together to enhance Melbourne's national and international reputation for excellence in financial practice, research and education. The Centre facilitates knowledge transfer between, and builds research synergies between, industry and academe by undertaking finance research, and organizing research focused conferences, workshops, public lectures and other educational activities. Financial Regulation is a core research area for the Melbourne Centre.

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