

**Increasing Household Financial Risk – An Increasing Social Risk?\***

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*Introduction*

When in their twenties, today's now elderly baby boomers virtually had to beg a bank manager to grant them a housing loan. They (like their parents before them) had to demonstrate loyalty to their bank by saving a sufficient deposit to bridge the substantial (thirty per cent plus) gap between any loan granted and the cost of house purchase. Interest rates were subject to government-imposed ceilings.

Few had a credit card, until the introduction of BankCard in 1974 and later arrival of Visa and Mastercard. Credit limits granted were conservative, and consumer credit by way of overdraft or personal loan was quite limited. Consequently household indebtedness, reflected in a debt/assets ratio of below 7 per cent in the early 1970s compared to over 17 per cent currently, was very low.<sup>1</sup> While individuals could borrow from other sources such as finance companies using hire-purchase (borrowing on the “never-never”) or invest in shares or other risky financial products (such as finance company debentures), such options were relatively limited, relatively simple, and relatively little used.

As a broad generalization, the young boomers were financially conservative, both in aggregate borrowings and in use of complex financial products. They had to be, because a regulated, non-competitive and non-innovative financial system gave them little option. They could also look forward to Governments largely financing their lifetime education, health and retirement income needs.

Now, Generations X and Y and the boomers themselves, at a different stage of their life cycle, face a markedly different financial world. Government policies (both here and internationally<sup>2</sup>) have tended to shift responsibility for bearing and managing financial

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risk increasingly onto households. A deregulated innovative financial world has expanded the range of financial products and strategies available to households, providing scope for better financial risk management but also allowing (and encouraging via advertising) greater financial risk taking.

But while financial deregulation has brought substantial and widespread economic benefits, it has also highlighted a growing problem. 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. The tip of this iceberg is reflected most clearly in situations such as the recent failures of property development financiers (Westpoint, Fincorp and ACR) where many individuals suffered substantial losses on investments inappropriate for their circumstances.

More generally 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. Consumers face a wide range of alternative, heterogeneous, complex and constantly changing financial products. Many are ill-equipped to assess risk and value for money. It is not obvious that, in these circumstances, competition will lead to the economist's nirvana of efficient (or even "fair") pricing. Indeed, in a recent Presidential address to the American Finance Association, John Campbell 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".<sup>3</sup> (Campbell, 2006).

These developments are the focus of this paper, which advances three main arguments. First, it is argued that Government policies are causing or providing incentives for individuals to take on increased financial risk (independent of any generational changes in attitudes to financial risk-taking). Second, the expanding range of complex financial products and services confronting individuals increasingly responsible for managing their personal financial risk creates two problems. One is that financially unsophisticated individuals are using unsuitable financial products. This creates the dual policy problems

of how to best prevent such situations and how to appropriately deal with the consequences when bad outcomes arise. The other is the risk 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.

The third argument is that 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.

In the following section, some evidence of the increase in financial risk being borne by households is presented. This is followed in section 2 by an analysis of some of the incentives for this trend. Then, in section 3, several examples are given of how competition and inappropriate incentive structures can lead to unsuitable financial products being widely adopted with undesirable social consequences. Some potential problems in the Australian context are also considered. Finally, implications for policy are considered and conclusions drawn.

## **1. Increasing Household Financial Risk**

Ultimately, individuals in aggregate bear the total risk of fluctuations in national output (income) and the value of real assets (wealth) of the economy. It may be in a role as direct investors in real assets (eg housing) or financial assets (equities, bonds) with uncertain future returns. This risk also arises via investments in superannuation and unit trusts, while risks taken on by financial institutions (such as banks) are also ultimately borne by individuals in their capacities as depositors or shareholders. Risk bearing also occurs through raising funds (borrowings) to be repaid from future uncertain income. Finally, risk bearing may be indirect (and largely hidden) in a role as taxpayers, through government policies involving transfer of particular risks away from those directly affected to the community more broadly.

Three trends in household risk bearing appear evident in this regard, both in Australia and elsewhere. First, there has been an increase in the aggregate level of direct financial risk taking by individuals. Second, Governments have, arguably, reduced the extent of risk transfer from individuals to taxpayers at large, and introduced policies which indirectly give incentives for increased household risk taking. Third, individuals are increasingly buying, or being sold, higher risk financial products, which if properly understood and used can generate substantial benefits, but otherwise create significant risks.

One commonly used measure of financial risk is the degree of leverage (debt/assets). The substantial increase in household sector leverage over the past three decades is shown in Table 1 using a variety of indicators. For example, the ratio of household debt/assets has doubled over the past two decades and the ratio of household interest payments/disposable income is now much higher than at its prior peak in the late 1980s when mortgage interest rates reached 17 per cent.

**Table 1: Household Leverage Trends: 1977 – 2007<sup>a</sup>**

Month	Housing			Total Financial			Housing
	Debt/ Assets	Debt/ Housing Assets	Debt/ Income	Assets/ Income	Assets/ Income	Interest Payments/ Income	Interest payments/ Income
Jun-1977	7.2	8.9	35.1	403.7	118.9	5.6	3.9
Jun-1987	8.7	11.9	44.6	436.4	174.6	7.8	5.4
Jun-1997	11.9	18.8	74.6	545.4	219.9	6.1	4.5
Jun-2007	17.2	26.3	161.2	826.1	328.8	11.9	9.5

<sup>a</sup> Income is defined as Disposable Income

Source: RBA Bulletin Table B21.

It is worth noting that this increased leverage is not apparently due to households borrowing to finance excessive consumption, as might be suggested by the declining and, since mid 2002, generally negative household savings rate recorded in the National Accounts. Once unrealized increases in asset values (capital gains on shares, houses, superannuation funds) are incorporated into measures of income and saving, the

household saving rate has remained relatively stable, positive, and comparable to those of overseas countries.<sup>4</sup>

Much of the increase in household debt has accompanied an increased value of holdings of financial or real (housing) assets. As Table 1 illustrates, the ratios of assets/income (both financial and total) have increased substantially over the past two decades, and significantly more than debt/income, emphasizing the increased importance of household financial risk management.

Several interpretations of this data are possible. One is the relatively benign view that financial deregulation has enabled households to adopt more suitable balance sheet structures consistent with life-cycle financing needs than the regulated system allowed prior to the 1980s. An alternative view is that households have taken on excessive risks, borrowing to engage in speculative asset purchases. A third is that economic conditions have changed (lower inflation and real interest rates, low unemployment and economic stability) in ways that make higher leverage an optimal strategy. A fourth is that demographic change is relevant. Most likely, all play some role, but there is little consensus on their relative importance. A recent analysis (incorporating international data) by Reserve Bank of Australia economists<sup>5</sup> suggests that changed economic conditions have played an important role, but that each of the other factors has some relevance. There is also little consensus on whether households, in aggregate, are too highly leveraged.

Another feature of household risk bearing is the composition of asset holdings. Most households have a significant proportion of their net wealth in housing.<sup>6</sup> For owner-occupiers with relatively small loans, and investing for long term accommodation reasons rather than as a speculative asset purchases, the resulting risks are relatively small. But investors and owner-occupiers who are highly levered can face substantial risks arising from interest rate and housing price movements, and the effect of changes in income on loan repayment capacity.

Within financial asset holdings, the share of “low risk” assets such as bank deposits has fallen from 27 per cent in 1992 to 19 per cent in 2007. In contrast, the share of superannuation (and life insurance) assets has increased from around 30 per cent to 49

per cent. The resulting increased exposure to volatility in asset prices from this change is magnified by the gradual shift from defined benefit to defined contribution (accumulation) superannuation accounts.

Using primarily US data, John Campbell<sup>7</sup> argues that there is evidence of a tendency for poorer and less educated households to make three types of serious financial mistakes: lack of participation in particular asset markets; inadequate diversification; and suboptimal decisions regarding refinancing of mortgages. These mistakes limit the ability of households to accumulate wealth without taking undue risk over the working phase of their lifecycle, an outcome which is compounded by inadequate voluntary savings in preparation for retirement.

These aggregate figures disguise many aspects of increased household risk taking, including the fact that a wide and growing range of sophisticated financial products is being increasingly marketed to unsophisticated retail investors. The boom in household stock market involvement associated with major privatizations such as CBA and Telstra, growing household financial wealth, and proliferation of self managed superannuation has widened awareness (if not understanding) of the range of financial products available. Instalment warrants (initially associated with the privatizations), contracts for difference (CFDs), margin lending, and capital investment protected products, are just a few of the types of products readily available. Even for products structured in ways which limit risk to retail investors, it is questionable whether most investors really understand the worth of the risk mitigation provided by the product providers (or potential “hidden” costs). Two poignant (overseas) case studies of widespread sales of unsuitable financial products to households, with important social and economic consequences, are outlined in a later section.

One further salient statistic which is relevant as a potential indicator of the outcome of increased financial risk taking by households is personal bankruptcies (although the consequences of small business failures also contribute to these numbers). Personal bankruptcies have trebled since the late 1980s from around 8,000 p.a. to around 24,000 p.a. currently, a figure equivalent to approximately one in every three hundred households. Whether this is too high, or consistent with an appropriate level of informed

financial risk taking by households, is an open to debate, but is suggestive of significant social problems.

## **2. Government Policy and Financial Risk Taking**

Various commentators have argued that government policies have had the effect of gradually increasing the self-responsibility of households for financial planning and risk management.<sup>8</sup> At a general level, this is reflected in reductions in government supplied and taxpayer financed services, including education and health, and particularly in the area of retirement income provision. While often the result of adoption of user pays criteria, these changes also involve transfer of responsibility for managing risk to the individual. Policies designed to enhance labor market flexibility tend to shift risks from employers to employees. As one commentator recently noted, “[w]hether it’s saving for retirement, meeting health costs, structuring employment or funding a child’s education, people today bear far more financial risk than their parents ever did.”<sup>9</sup>

The trend seems likely to continue with advances in technology and communications enabling product and service producers to adopt different delivery and pricing arrangements for households. Coming down the track, for example, are such things as smart meters for electricity involving time-of-day pricing related to production cost fluctuations which, while aimed at inducing more efficient consumption, pass price risk onto consumers.

More direct influences occur via explicit policies. Taxation gives incentives for financial risk taking which financial deregulation has enabled individuals to exploit. The main factor is the concessional tax treatment of capital gains income accompanied by the allowance of negative gearing. Superannuation policy is also contributing to increased risk taking in subtle ways.

### *Capital Gains and Negative Gearing*

Assets which generate returns in the form of capital gains involve risk, since the magnitude of returns is uncertain and may involve capital losses. Typical examples include shares and investment properties.

Under tax policy changes introduced in the late 1990s, only half of realized long term capital gains (on assets held for more than twelve months) are included in assessable income. However, all of the interest on borrowings to finance purchase of such assets is tax deductible. That tax deduction can be claimed each year against other (unrelated) income (such as wages) even though capital gains will not be taxed until realized (when the asset is sold) at some future date. This practice, known as “negative gearing” (when annual tax deductible borrowing costs exceed taxable income such as dividends or rent from the asset) increases what is already a tax driven incentive for individual investors to enter into leveraged transactions.

Consider a very simplified example of an individual, on a 30 per cent tax rate with no accumulated wealth, who is able to borrow \$100 at an interest rate of 8 per cent p.a. to invest in an asset such as shares which are assumed to also have an expected return in the form of capital gains of 8 per cent p.a.<sup>10</sup> Suppose the shares are to be sold after one year and the borrowing repaid. Because only 50 per cent of the expected capital gain will be taxed while the entire interest expense will be tax deductible, the expected net return after tax is \$1.20.<sup>11</sup> There is, of course a risk with this strategy. The price of the asset purchased may fall, or have a low return such that the actual return after tax is negative.

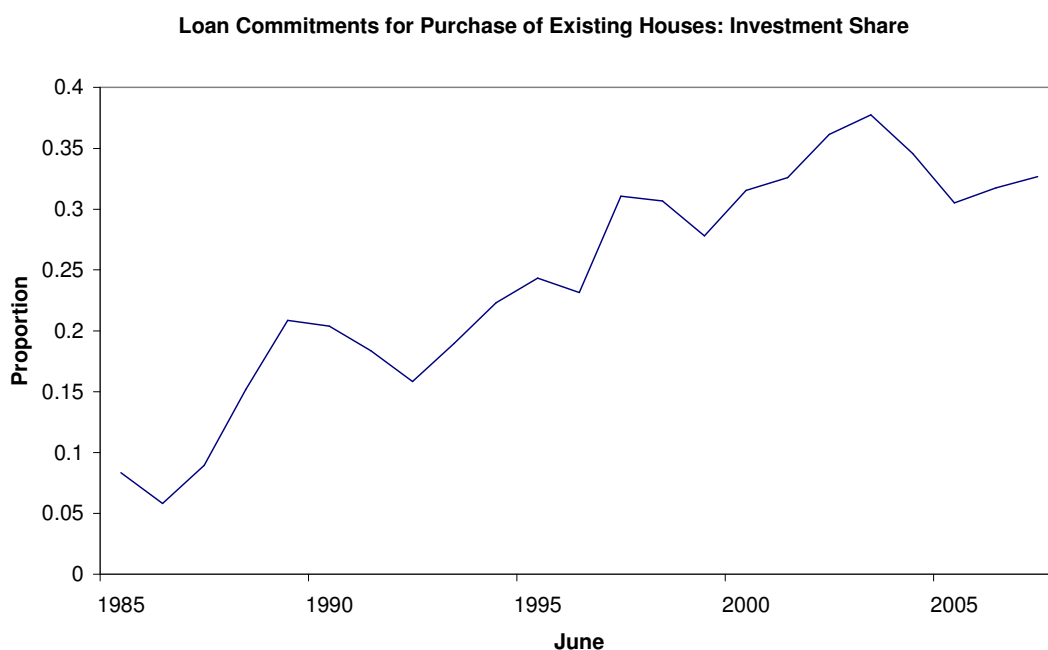
Three important points follow from this simple example. First, there is an incentive to increase the scale of this strategy (particularly if the risks are not fully appreciated). Borrowing and investing \$1 million (still no net cash outlay by the investor) has, in this example, an expected net return after tax of \$10,200 p.a. Second, both the expected after tax return and size of risk increases in magnitude with the scale of the strategy. Third, there is no net social benefit (and possibly a cost) associated with the individual pursuing the strategy in this example – the asset being purchased offers only the same pre tax expected return as the borrowing cost, even though it is riskier. In this example, expected gains of the investor are at the expense of other taxpayers.

Implementing such strategies requires the cooperation of lenders. They must be willing to provide finance for such risk-taking activities. And, in the deregulated financial environment, they have. Margin lending for investment in shares has increased from around \$6.5 bill in mid 2000 (with under 85,000 clients) to \$36 bill with 186,000 clients



in mid 2007. Lending for residential investment properties relative to owner occupation has also increased markedly, as indicated in Figure 1 which illustrates that loan commitments for investment in existing properties has increased substantially relative to those for owner-occupiers.<sup>12</sup> Over 4000 warrant type products (many of which involve implicit leverage provided to the investor by the investment bank issuer) were listed on the ASX and available to retail investors at the end of October 2007.

**FIGURE 1**



Source: RBA Bulletin Table D06.

### *Superannuation Policy and Individual Risk-Taking*

In principle, superannuation policy is aimed at reducing the risk that individuals will have insufficient accumulated wealth to finance an acceptable life-style in retirement. In practice, it has some subtle effects on household risk-taking.

First, it has been one of the major factors in the change in composition of household portfolios away from low-risk assets. As Chris Ryan and Chris Thompson note<sup>13</sup>, the ratio of household financial assets to income has increased from 170 per cent in 1990 to 315 per cent in 2007, but holdings of cash and deposits have stayed relatively constant at

around 50 per cent. The increase reflects superannuation accumulation style investments (contributing an increase of 100 per cent) and direct investments in equities or unit trusts, where the investor is exposed to price risk.

Second, the forced, or tax-induced, increase in financial wealth tied up in illiquid superannuation savings, should affect household portfolio decisions outside of superannuation. One consequence is lessened ability to accumulate wealth for investment in assets such as owner-occupied housing (which has significant tax advantages as well as its emotional appeal). Allied with apparently more relaxed attitudes to debt of younger generations, and a competitive housing loan market, there appear to have been substantial increases in average loan to valuation ratios for housing lending.<sup>14</sup> In aggregate, the ratio of housing debt / housing assets has more than doubled in the last two decades, and the ratio of housing interest payments / disposable income in 2007 of 12 per cent far exceeds the 9 per cent peak at the start of the 1990s when housing mortgage interest rates reached 17 per cent.

Within those aggregates there is substantial variation at the individual level with some 67% of households in 2003-4 having little or no debt (defined as a debt-servicing ratio to disposable income of less than 4%).<sup>15</sup> At the same time, a significant number of households had substantial debt. For example, ABS figures for 2005-06<sup>16</sup> indicate that around 25 per cent (almost three quarters of a million) of owner-occupiers with a mortgage faced repayments in excess of 30 per cent of gross income – a situation referred to by many commentators as mortgage stress.

The risks faced by these highly levered individuals are significant, although of the low probability, high impact variety. Interest rate increases accompanied by a housing market downturn, can create substantial repayment problems and an inability to liquidate the underlying asset.

Third, while explicit borrowing for leverage of superannuation funds is not permitted, inconsistencies in the tax law provide opportunities for indirect leverage and exploitation of the tax gains from leverage as outlined earlier. Financially engineered products such as instalment (and other) warrants effectively enable investors to purchase shares for an

initial outlay of perhaps half of the current share price, with a final instalment to be paid at some later date. The remainder of the initial cost of the share purchase is met by the investment bank which issues the warrant, which involves an implicit loan packaged up in the warrant product and repaid with interest via the final instalment. In September 2007, Parliament passed changes to the tax laws permitting superannuation funds to apply this indirect method of leverage to a wider category of assets through arrangements involving non-recourse borrowing.<sup>17</sup> This further increases the opportunity for individuals with self managed superannuation funds to take on increased risk in seeking to exploit tax advantages provided by superannuation.

### **3. Calamities in Retail Financial Innovation**

To date, Australia has not experienced wide-spread social and economic problems from herd-like shifts of households into innovative financial products which involve substantial risks. But it can happen, as recent experiences of the UK and USA illustrate. In both cases, inappropriate incentive structures for product sellers, and ability of mortgage originators to transfer resulting risks to others played important roles.

#### *The UK Endowment Mortgage Fiasco*

In the UK, a major problem emerged in the late 1990s due to many households having been encouraged by lenders over the preceding decade to enter into *endowment mortgages*. This type of product which accounted for over 80 per cent of mortgages written in 1988<sup>18</sup> converted an otherwise standard housing mortgage into a levered stock market investment. Regular mortgage loan repayments normally involve both an interest component and a repayment of principal which gradually reduces the amount outstanding. However, in the case of endowment mortgages, the principal component was allocated instead as payments to an endowment style insurance policy and used to build up an equity portfolio. A smaller principal component payment than in a standard mortgage was allowed for, because the endowment policy would be generating returns from the equity investments. The “logic” was that the expected return on the equity market is greater than the mortgage interest rate, and there were tax benefits associated with these arrangements. Thus over a longish term the accumulated sum in the

endowment policy would be sufficient to repay the loan principal outstanding, and total payments by the borrower (principal plus interest) would be less than otherwise.

With hindsight, the risks are obvious. There can be substantial periods when the stock market return fails to exceed market interest rates, or can be negative. And so it turned out to be. Even after substantial restructurings and policy interventions, in 2005, there were 2.2 million households facing a shortfall (expected endowment policy value relative to principal owed) of GBP 7,200 on their endowment mortgage policies.<sup>19</sup>

#### *The US Sub-Prime Mortgage Fiasco*

More recently in mid 2007, the US (and the rest of the world through securitization) has experienced financial turmoil as a result of the proliferation of sub-prime residential mortgage lending and competition for business leading to high risk structures and inadequate credit risk margins on the terms of such loans. Such sub-prime loans were to borrowers who had poor credit ratings and often for high loan to valuation ratios. A common structure involved an introductory (relatively low for the credit risk involved) interest rate fixed for two years and then adjusting to variable market rate levels, and with substantial prepayment penalties. There were over 3 million sub-prime mortgages written each year between 2004 and 2006 of which around 45 per cent were adjustable rate mortgages, 10 per cent allowed for negative amortization, and 20 per cent were interest only.<sup>20</sup>

Many low income borrowers took out such mortgages, hoping to refinance their loan after the initial two year period when increased house prices and possibly improved income would enhance their credit rating. They often did not fully appreciate the risks such as stagnant or declining house prices and costs involved in early refinancing, with these factors coming home to roost in the high levels of delinquencies which provoked the “sub-prime crisis” of 2007. As well as the ramifications for international financial markets due to the transfer of the default risks via securitization, US policy makers have been searching for ways of preventing a tide of mortgage foreclosures creating a major social problem.

*The US and UK Experience: Common Factors*

In both of these cases, households entered into financial products involving substantial risk which were clearly unsuitable for their circumstances. In the UK case, agents received front end loaded commissions for selling the endowment mortgage product, in which households took on equity market risk. In the US case, loan assessment was outsourced to mortgage originators who received fees for writing mortgages, the default risk of which was transferred to capital markets via securitization. Agents involved in the process had incentives not aligned to the best interests of the home-buyers they were dealing with, and those home-buyers arguably were unable to fully appreciate or understand the risks involved. That such wide ranging fiascos could emerge in recent years in retail financial markets of two of the most sophisticated financial systems in the world is suggestive of major underlying problems in the compatibility of unfettered competition in retail financial markets and consumer safety.

*Some Potential Australian Concerns*

Although there have been numerous isolated instances of unsuitable financial products and practices being sold to Australian households over recent decades, there have been no instances of the systemic problems outlined above. (Even the Westpoint, ACR and Fincorp failures which have received significant press only involved some 20,000 investors). But that does not mean that there are not a number of potential flashpoints, where large numbers of households could face common problems arising from emerging financial strategies of the different generations.

For the boomers, three potential problems warrant mention. First, government tax policy and superannuation are encouraging the growth of self managed superannuation funds, of which there are around 360,000 (and growing) as at mid 2007. As Owen Covick points out<sup>21</sup>, little attention has been paid to the public policy issues associated with the costs and management of these funds once they move into the pension phase. The trustee with the implicit primary responsibility for managing the fund may die or become incapable. As the fund balance declines through payment of a pension, the administration costs become relatively large compared to the balances under management. Policies need to be

designed to enable easy wind-up of such inefficient or non-working structures and transfer of those affected to more suitable retirement income solutions.

Second, favorable tax treatment of retirement income streams has been gradually broadened over time to include products such as allocated pensions and lump sum withdrawals. Use of these retirement income options creates the possibility of “longevity risk”, whereby accumulated savings are exhausted before death (because of excessive consumption, poor investment returns, or unexpected longevity). Widespread use by retirees, many of whom may experience poor investments or underestimate their lifespan, poses a potential future problem for social and economic policy.

The third problem relates to retirement accommodation needs. Retirees face a range of options which involve both financial and lifestyle considerations including uncertainty over future health and support arrangements. While some may wish to preserve capital for their heirs, many will want or need to run down the capital tied up in their real estate. Options include remaining in the family home and using a (newly popular) reverse mortgage to drawdown capital for living expenses, “downsizing” to a smaller home and releasing capital, selling and entering some form of (usually complex) contract with a retirement accommodation provider. Not only are the choices financially complex with future costs and risks hard to assess, some of the options are largely irreversible. The potential looms large of poor product design, poor advice, and lack of knowledge leading to significant numbers of cases of poor financial decisions and hardship.

For Generations X and Y, the principal current problem is the risk taken on through highly levered housing purchases (currently compounded by high house prices and low affordability). In principle, given the required working-life contributions to, and consequent, accumulation of wealth in superannuation funds, increased housing debt leverage may seem perfectly rationale. Funds which would otherwise have been saved and used for a house purchase are invested instead in superannuation and replaced by increased borrowing. But doing so, and aiming for the same value of housing purchase as in the absence of superannuation savings, requires either an increase in overall leverage, or an increase in total savings (rather than just a transfer between housing deposit savings and superannuation). The latter does not appear to have occurred since younger

generations appear to have a culture not conducive to high savings and a greater willingness to utilise credit. And the former can be a potentially risky strategy, since the earnings on superannuation assets (and that wealth) are quarantined until retirement. They are thus not accessible should the repayments associated with housing leverage prove excessive due to increased interest rates or loss of wage income.

#### **4. Policy Responses**

With increasing responsibility for managing their own financial risk throughout the life-cycle, there is increasing concern about the gap between the financial acumen required and that possessed by individual households. Identifying and understanding the significance of various risks and how they are interrelated, determining an optimal risk position, and choosing between a plethora of complex financial products and strategies to effect financial transactions to achieve a desired risk position are not simple and straightforward tasks. Individuals can also be sold financial products on the basis of incorrect or misleading information, raising the question of what are the appropriate mechanisms (such as official action or private (class action) legal proceedings) for seeking redress.

For those with relatively comfortable net worth positions, the option exists of paying for specialized advice from financial advisers – an industry whose growth reflects both the transfer of financial risk management responsibility to households and the increasing complexity of the financial system and associated tax and regulatory rules. Unfortunately, this involves an agency problem of substantial magnitude. Financial advisers are increasingly interlinked with the major financial institutions which provide the advisers with technology, information, transactions services and financial products (such as unit trusts) for their clients. In many cases, such as in those of debt securities issued by now failed property development companies Westpoint, Fincorp and ACR, advisers received substantial commission rates from those companies for funds raised from the investors they were advising. Whether “independent” or “best practice” advice can be expected in those circumstances, let alone whether it represents good “value for money” is problematic.

But it is the situation of those with relatively low net worth positions where the problems are most great. The cost of professional financial advice is for such households sufficiently relatively high as to make it unaffordable. And because there is likely to be a positive correlation between financial expertise and net worth for any age cohort (due to educational and/or skill factors) it is these households most in need of such advice. Such groups may, perversely, because of budget constraints tend to bear higher risks due to under-insurance for health, assets, and death.

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. Finance may not be as difficult as medicine, but self diagnosis and self prescription for financial health may be not much better than for medical health. Probably the best that can be hoped for is by analogy with health awareness campaigns, providing help in identifying between healthy and unhealthy lifestyles. But just as those campaigns are undermined by massive advertising campaigns by purveyors of junk food etc, so also are households continually tempted with financial products (loans, speculative investments) unhealthy for them.

Compulsory disclosure requirements for sales of financial services or products to retail customers are also an imperfect solution. They are often ignored or not understood by consumers. Rarely do they provide stark warnings of the form “this product is hazardous to your wealth” similar to requirements for some other consumer products.

To date, policy towards dealing with the consumer knowledge gap surrounding financial services have focused on the triumvirate of approaches of education, advice and disclosure discussed above. But, given their limitations, complementary strategies warrant examination including the following.

At one extreme (and anathema to free market ideologues) would be the imposition of restrictions on the range of allowable financial products and services which can be marketed to retail customers. To some extent, this occurs already, with regulatory distinctions between “wholesale” and “retail” products, with the former products having lesser disclosure requirements and available only to wholesale (sophisticated) investors. But perhaps there are grounds for wider application. For example, Australia is relatively



unique in allowing organizational structures which provide opportunities for retail investors to easily invest in such sophisticated, potentially high risk, financial products as hedge funds, private equity, and collateralized debt obligations. Proceeding too far down this route would, however, be a risky strategy, since the ability of bureaucrats to readily identify financial products which are generally unsuitable for a heterogeneous group of households is undoubtedly limited.

A second possibility, suggested by John Campbell<sup>22</sup> involves Government specification of the “default option” for particular financial products where there is a range of possible characteristics. For example, the default option specified for a retirement income stream could be specified to be a lifetime annuity, with retirees having to explicitly choose to shift to some other product such as an allocated pension. Behavioral finance suggests that individuals will be more likely to remain with the default option than shifting to an alternative product. Individuals may also associate the specification of the default option as conveying valuable information to them about products with suitable risk characteristics for their situation. Specifying default options most suitable for the case of poorly informed retail customers would thus appear to have merit, and not prevent financial institutions from also marketing other products.

A third strategy involves use of tax and subsidy arrangements. Where particular financial products or strategies are believed to be generally unsuitable for household use (and where social costs may flow from inappropriate financial risk management) there may be merit in using the tax system to influence decision making. This is, of course, already done in the form of tax concessions for superannuation, without occasioning significant dissent amongst economic commentators. Extending the scope of such interference with the price mechanisms to specific products may generate concerns, but warrants examination. Unfortunately, at the moment, some such interferences take forms (such as concessional capital gains tax as discussed earlier) which tend to increase household financial risk taking.

A fourth strategy involves building upon the education, advice, disclosure triumvirate currently applied. One possible approach involves encouraging greater availability of independent third party appraisal of financial product risk. This has been one component

of the regulatory response to the recent failures of property finance developers, which has recommended that third party ratings be required for unlisted debentures. However, as noted by the Australia-New Zealand Shadow Financial Regulatory Committee<sup>23</sup> there are concerns about the independence and value added provided by ratings agencies.

Another possible initiative in this vein, would be for governments to improve the information available to households when making the largest and most significant decisions in their financial life-cycle. Housing purchases are typically made with very imperfect information about current house values and their recent trends. The required registration of transfers of ownership (for land titles and stamp duty purposes) generates a readily available data base of sale price and house characteristics information which, with modern technology, could be easily made widely available to households, at low or zero cost, to facilitate their investment and financial decision making. Undoubtedly there are vested interests who would see this as an undesirable development.

Additional approaches could involve supporting the development of markets for currently unlisted financial products which would increase information available to consumers (about others' valuations of the products) and enhance "exit" mechanisms for those wanting to reduce their holding. And while there are web-sites and other information sources which provide "independent" comparative assessments of some characteristics of some types of financial products, there does not appear to be the same depth or breadth of offerings as for many consumer goods and services (restaurants, hotels, consumer durables etc). That may be because the suitability of any financial product for a particular individual depends crucially on that individual's personal circumstances, making generic assessments of less value. Nevertheless, there would appear merit in examining whether there are impediments (such as excessive exposure to legal liability) which inhibit development of such third-party rating services.

## **5. Conclusion**

A deregulated competitive and innovative financial services sector generates significant economic benefits, but can create economic and social problems through the sale of unsuitable financial products to poorly-informed households which lead them to bearing unwarranted risks or incurring excessive costs. Adopting policies to reduce information

deficiencies and applying a “caveat emptor” approach is unlikely to be sufficient to prevent the emergence of substantial problems which governments will feel compelled to resolve through budgetary or other measures. Other forms of policy intervention, such as discussed above, would seem to warrant consideration and rigorous cost-benefit analysis to determine their merit in balancing the benefits of competition and innovation in financial services with consumer protection.

Unfortunately in examining policy options in the retail finance area, there is a dearth of publicly available, high quality, data, which is a problem also identified for the US by Campbell.<sup>24</sup> Rectifying that gap, and developing improved statistical tools “to capture the distribution of risks across population subgroups, especially age and income cohorts”<sup>25</sup> are key steps in moving forward.

## ENDNOTES

<sup>1</sup> See Battellino Ric (2007) “Some Observations on Financial Trends” *Finsia-Melbourne Centre for Financial Studies 12th Banking and Finance Conference* Melbourne 25 September  
[http://www.rba.gov.au/Speeches/2007/sp\\_dg\\_250907.html](http://www.rba.gov.au/Speeches/2007/sp_dg_250907.html)

<sup>2</sup> IMF (2005) *Global Financial Stability Report*, (Chapter 3, Household Balance Sheets) IMF  
<http://www.imf.org/External/Pubs/FT/GFSR/2005/01/pdf/chp3.pdf>

<sup>3</sup> Campbell John (2006) “Household Finance”, *The Journal Of Finance*, LXI, 4, August, 1553-1604.

<sup>4</sup> RBA (2006) “Box D: Capital Gains and Measures of Household Saving” *Statement on Monetary Policy*, May [http://www.rba.gov.au/PublicationsAndResearch/StatementsOnMonetaryPolicy/May2006/box\\_d.html](http://www.rba.gov.au/PublicationsAndResearch/StatementsOnMonetaryPolicy/May2006/box_d.html)

<sup>5</sup> Kent Christopher, Crystal Ossolinski and Luke Willard (2007) “Household Indebtedness – Sustainability and Risk” *The Structure And Resilience Of The Financial System*, Reserve Bank of Australia Conference – Sydney, 20 - 21 August 2007.

[http://www.rba.gov.au/PublicationsAndResearch/Conferences/2007/kent\\_ossolinski\\_willard.pdf](http://www.rba.gov.au/PublicationsAndResearch/Conferences/2007/kent_ossolinski_willard.pdf)

<sup>6</sup> The aggregate ratio of housing assets/financial assets for the household sector has hovered in the region of 1.3 – 1.5 for the past two decades.

<sup>7</sup> Campbell (2006) *op cit*

<sup>8</sup> See, for example, Kell Peter (2006) “Consumers, Risk and Regulation” *National Consumer Congress* 17 March 2006

[http://www.consumer.vic.gov.au/legalchannel/DOJFileLib.nsf/431208904c216a074a2567c1000caf66/b309b02ab6edb9bdca25713a001c8db7/\\$FILE/PKellSpeech\\_approved.doc](http://www.consumer.vic.gov.au/legalchannel/DOJFileLib.nsf/431208904c216a074a2567c1000caf66/b309b02ab6edb9bdca25713a001c8db7/$FILE/PKellSpeech_approved.doc)

<sup>9</sup> Smith Mark (2007) “Taking Up the Burden” *Money Management*, 1 November.

[http://www.moneymanagement.com.au/Articles/Taking-up-the-burden\\_0c05087c.html](http://www.moneymanagement.com.au/Articles/Taking-up-the-burden_0c05087c.html)

<sup>10</sup> Apart from assuming equal pre tax borrowing cost and expected investment return, this example is simplified in several other ways which mean the expected gains from leverage may be understated. Because capital gains are only taxed when realized, a longer investment horizon means that these tax liabilities may be deferred relative to the tax deductions available from borrowing and which can be offset against other current income. Full tax deductibility of capital losses against subsequent capital gains can also create a bias towards assets promising returns by way of capital gains rather than as interest or dividends even in the absence of leverage for some taxpayers.

<sup>11</sup> If  $r$  represents the borrowing cost and expected investment return, and  $t$  is the tax rate, the after tax return from borrowing and investing \$100 is given by  $Y_{at} = \$100[r(1-0.5t) - r(1-t)] = \$100(0.5)rt$ . If  $t = 30$  per cent and  $r = 8$  per cent p.a., the expected return after tax is  $Y_{at} = \$1.20$ .

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<sup>12</sup> The share of lending commitments for construction of new dwellings for investment purposes has been more volatile than that for purchases of existing dwellings, but with no obvious trend.

<sup>13</sup> Ryan Chris and Chris Thompson (2007) "Risk and the Transformation of the Australian Financial System" The Structure And Resilience Of The Financial System, Reserve Bank of Australia Conference – Sydney, 20 - 21 August 2007.

[http://www.rba.gov.au/PublicationsAndResearch/Conferences/2007/ryan\\_thompson.pdf](http://www.rba.gov.au/PublicationsAndResearch/Conferences/2007/ryan_thompson.pdf)

<sup>14</sup> Unfortunately there is no readily available time series data on average loan/valuation ratios to directly substantiate this widely held impression.

<sup>15</sup> Braddick Paul (2006) "Is Credit Growth Sustainable" Economic Papers, Special Edition, December, 71-79.

<sup>16</sup> ABS (2007) Housing Occupancy and Costs, 2005-6, Australian Bureau of Statistics, Cat. No. 4130.0.55.001 (Table 5A).

<sup>17</sup> Tax Laws Amendment (2007 Measures No. 4) Act 2007 No. 143, 2007 "Superannuation Industry (Supervision) Act 1993 subsection 67(4)"

[http://www.austlii.edu.au/au/legis/cth/num\\_act/tla2007mn4a2007314/](http://www.austlii.edu.au/au/legis/cth/num_act/tla2007mn4a2007314/)

<sup>18</sup> ABI (2005) Mortgage Endowments: A Factsheet, Association of British Insurers, July 2005

[http://www.abi.org.uk/BookShop/ResearchReports/FINAL%20Mortgage%20Endowments%20Factsheet%20\(July%202005\).pdf](http://www.abi.org.uk/BookShop/ResearchReports/FINAL%20Mortgage%20Endowments%20Factsheet%20(July%202005).pdf)

<sup>19</sup> *ibid*

<sup>20</sup> Demyanyk Yuliya and Yadav Gopalan (2007) "Subprime ARMs: Popular Loans, Poor Performance", Bridges, Spring, Federal Reserve Bank of St. Louis <http://stlouisfed.org/publications/br/2007/a/pages/2-article.html>

<sup>21</sup> Covick Owen (2007) "Self Managed Allocated Pensions: Public Policy Issues" JASSA, December (forthcoming).

<sup>22</sup> Campbell (2006), *op cit*.

<sup>23</sup> ANZSFRC (2007) "Responding to Failures in Retail Investment Markets" Statement No. 3 Australia-New Zealand Shadow Financial Regulatory Committee, Melbourne, September 25.

[http://www.melbournecentre.com.au/ANZSFRC/ANZSFRC\\_Statement\\_No3.pdf](http://www.melbournecentre.com.au/ANZSFRC/ANZSFRC_Statement_No3.pdf)

<sup>24</sup> Campbell (2006) *op cit*

<sup>25</sup> Groome W. Todd, Nicolas Blancher, and Parmeshwar Ramlogan (2006) "Aging and Financial Markets" Finance and Development, September, Volume 43, Number 3

<http://www.imf.org/external/pubs/ft/fandd/2006/09/groome.htm>