



UiO : **University of Oslo**

An economist's view

By Diderik Lund, Department of Economics
at the seminar 12 March 2013 on
Investment Services and Consumer Contract Law
at the Department of Private Law



Own background

- Professor of economics
 - 20 yrs teaching and research in financial economics, i.a.
 - No background in law studies; limited understanding
- Member of Borgarting appeals court («fagkyndig meddommer», «expert lay judge») in 2011–12 in case on financial investment product sold in 2007 by Fokus Bank, branch of Danske Bank
 - Court's majority of 4 decided that bank was not to blame
 - I (DL) was minority of 1, finding that bank should compensate losses of customers due to misinformation
 - Supreme Court unanimously upheld majority's conclusion

Outline of talk

Much is related to Fokus case, but with general interest

- Perspective: Need new legislation/regulation?
- Why sell financial products to non-professionals?
- Supreme court concentrated on «small print»
- Duty to give reasonable advice?
- Professionalism of customers is a difficult concept
- Professionalism of banks is highly doubtful
- Plaintiffs responsible for suggesting alternative info?
- Collective or individual lawsuits?

Perspective: Need new legislation/regulation?

- Worried by rulings by Supreme Court in Lognvik case (February 2012) and Fokus case (December 2012)
- Hope not only to understand, but suggest improvements, which will have to come in legislation and regulations
- Perhaps different after ruling in Røeggen case (expected March 2013) and after MiFID (these cases originated before MiFID was introduced)
- If no new legislation/regulation, banks can continue to
 - offer product packages (explicitly including optional debt financing) which are obviously unfavorable when costs of debt and various fees and margins are taken into account (Lognvik, Røeggen)
 - offer products which are neither fully understood by customers nor by bank employees at the time when they are being sold (Fokus)

Why sell complicated financial products to non-professionals?

- By «complicated» I mean: Defined by a formula (with observed market values as inputs), often time-dependent, more complicated than a sum
 - Uncomplicated: Fund made up of traded shares or bonds
 - Complicated: Endless possibilities; often nontraded options
- Several problems with complicated products
 - Almost impossible to understand for most bank customers, but also for many bank employees (proved beyond reasonable doubt in Fokus case, as I see it)
 - Not transparent pricing of nontraded elements
 - Several layers of «normal» transaction fees, risk margins, etc., are detrimental for net profitability for customer

Why sell complicated financial products to non-professionals, contd.

- **Positive: Multitude of financial products**
 - allows diversification for individuals, and spreads risks across many
 - improves information aggregation in markets, since many types of information can be traded upon
- **Negative: Complicated products**
 - do not allow customers to make rational decisions, since information is not understood
 - increase information asymmetry of banks versus customers
- **Conclude: Restrict these products to professional customers, who may understand them, who may have the particular needs for specialized diversification, and who may reveal information**

Fokus case: Supreme Court (SC) concentrated on «small print»

- Explicitly: Paragraph 53 in ruling states that the deliberations in the SC have been concentrated on the written information material of the bank.
 - Implies that the SC chooses to neglect other evidence on information given to customers, such as «Riseng's note»
 - Those who invest > ½ mill NOK must rely on small print
- In my opinion, a suprising and dangerous view
 - Worrying in principle, not only based on the actual divergences in different pieces of information in Fokus case
 - If this remains the legal situation, no one who invests large amounts can do this based on the totality of information presented to them, convincingly by bank employees who themselves do not understand the small print

SC concentrated on «small print», contd.

- In Fokus case, as I see the evidence:
 - Customers had invested in syndicated senior bank loans, i.e., a collection of shares (fractions) of secured («senior») loans from US banks to firms in the US
 - But these loans are securitized (converted to tradable securities) and traded in a second-hand market, and customers were not informed about the pricing in this market, and consequences this could have for them
 - SC found it sufficient that the existence of the second-hand market was mentioned a few places in 48-page material
 - SC neglected that information from bank employees to customers completely ignored the second-hand market

Duty to give reasonable advice?

- In some cases (Lognvik, Røeggen) product package (with optional debt financing) is in itself unreasonable
- In other cases, unreasonable results may occur due to advice given by banks
- After looking into 29 customer relations in Fokus case (and suspecting this is widespread), I observe
 - Bank ignores customer's total portfolio situation (including all lifetime wealth; home, labor income, debt, pension, etc.)
 - In some cases customer was advised to borrow to invest, in spite of central information material suggesting this investment should amount to ≈ 10 percent of portfolio
- New regulation should require such a suggestion (e.g., 10%) announced for each product; customers required to sign that they were informed of it

Professionalism of customers: What does it mean?

- Fokus Bank sold products spring 2007 before MiFID
- MiFID has hopefully improved situation
- My interpretation: customers seen as professional by SC, who required them to understand details
- Based on amount invested $> \frac{1}{2}$ mill NOK
 - Clearly meaningless when customers (are advised to) invest their total savings *or more* in this product, since many retirees have wealth at this level (although often illiquid)
- Other unreasonable criteria used (from economist's view):
 - Professional if invest through own firm (– advised by bank)
 - Professional if active in market for several years
- Better confine «professionalism» to education and job

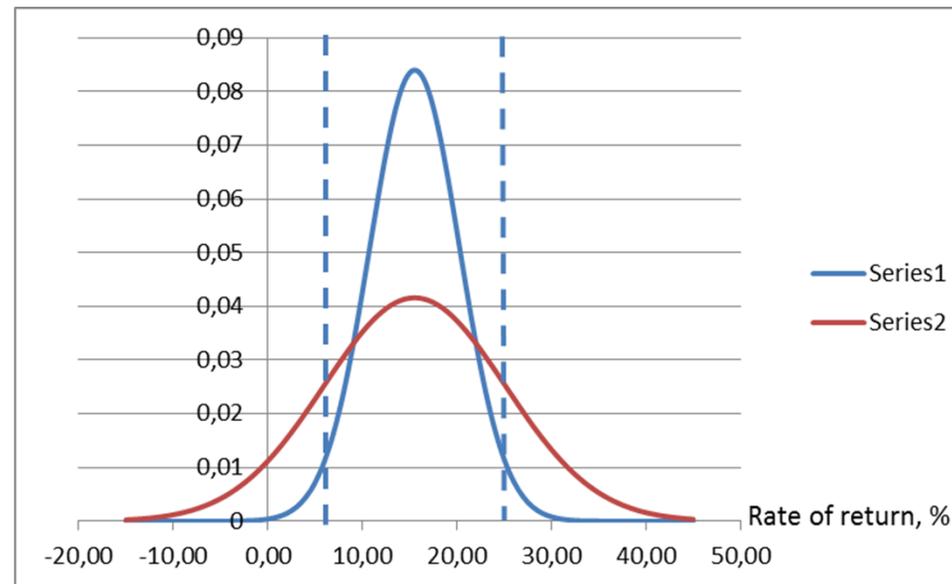
Professionalism of bank?

- Banks required to serve interest of customers
- Apart from this, professionalism seldom questioned
- When professional behavior is required of customers (read small print, understand, ignore other info), banks should also be held to professional standards
- Cannot rely on argument that what everybody else does, is good enough
 - Repeatedly made in Fokus case, as defense when weaknesses in written material were pointed out
- Cannot rely on argument that quantitative mistakes do not matter because numbers are unimportant
- Should not switch views on statistic properties of products as it suits the bank, in order to persuade

Professionalism of bank, contd.

- When selling to non-professionals, total information picture is problem; customers cannot sort out themselves
- When selling to professionals, the exact contents become relevant; customers must be able to rely on detail, requiring professionalism of quantitative information
- Between appeals court and SC, Fokus revised its view and admitted mistake in statistical information
- Only one point in my long list of objections (see minority dissenting opinion) was admitted to, as a mistake
- When product was sold, customers were told that based on historical data, the rate of return would fall between 6.23% and 24.83% with 95 percent probability
- Revised view in SC case was that it would fall in that same interval with 67 percent probability (but no calculation given)
- Huge difference, implying 100 x higher probability for negative

Illustrating difference between 95% and 67% probability that yearly rate of return falls between 6.23% and 24.83%



- Assumption here (and in court): Gaussian («normal») distribution (– maintained here despite my own reservations)
- Blue curve shows Fokus Bank’s original estimate
- Red curve shows revised estimate by bank’s experts for SC
- Blue vertical, dashed lines show (6.23%,24.83%) interval
- Probabilities of negative outcomes are 0.06% vs 5.26%

Documentation of diagram in slide 13

- Some documentation is desirable, in particular because the diagram's information is at odds with paragraph (79) in SC ruling (which was supposed to set things right, based on renewed input from the expert witnesses after appeals court case)
- The intention of slide 13 is to make the comparison that the SC was supposed to do, between original estimates and new estimates, both supplied by the bank, and both based on the assumption of a Gaussian («normal») probability distribution (which seems to be maintained by the bank, although I am not 100 percent sure about this)
- The diagram in slide 13 is calculated by myself, using Microsoft Excel, as follows:
 - The original estimates were based on five years of historical data; the estimates describe a Gaussian («normal») probability distribution for annual rates of return on the Note, with mean (also called «expected value») equal to 15.53% and a 95% confidence interval of (6.23%,24.83%), a distance of 9.30 percentage points at each side of the mean
 - The interval is defined by the 2,5% and 97,5% fractiles of this distribution, and one can thus calculate the standard deviation of the distribution; the usual procedure is to start with a standard normal distribution, in which these two fractiles are -1.96 and 1.96, respectively; using the fact that the width of the confidence interval is proportional to the standard deviation, one must thus have a standard deviation of $(9.3/1.96)\% = 4.75\%$ in the original distribution described in the bank's fact sheet of 2007
 - The new information in 2012 that the probability of outcomes in the given interval (6.23%,24.83%) is only 67%, should imply that there is a new standard deviation; no information is given about a new mean, so one has to assume this is unchanged at 15.53%; the same interval is thus defined by the 16.5% and 83.5% fractiles (the only symmetric interval with 67% probability mass); these fractiles are -0.97 and 0.97 when the standard deviation is 1 (unity); the new 67% number is thus consistent with a new standard deviation of $(9.3/0.97)\%=9.59\%$, repeating the assumptions:
 - both old and new distribution are Gaussian
 - mean is unchanged at 15.53%
 - Under the old distribution, the probability of negative outcomes is the probability of ending up 15.53 percentage points below the mean, which amounts to ending up $(15.53/4.75)\times 4.75=3.27\times 4.75$ percentage points below the mean, where 4.75 is the standard deviation; using probability tables, the probability of ending up 3.27 standard deviations below is equal to .0006, or .06 percent
 - Similarly, for the new distribution, the probability of $(15.53/9.59)\times 9.59=1.62\times 9.59$ below is 0.0526 or 5.26 percent
 - This is not consistent with the claim by the SC in paragraph (79), that the new 95% confidence interval is (3.03,27.78)

Professionalism of bank, contd. (now into details)

- Bank should be required to describe all known consequences of an investment, as seen from the customer's point of view
 - including fees and margins, including borrowing if that is part of package
- Regarding statistical information (probabilities of outcomes, expected values, standard deviations, etc.), requirement today is to give information based on 5 years history, if available
- Problem if investment is sensitive to rare events (less frequent)
- Also required info on probable interval of outcomes (cf. above)
- Fokus did several mistakes here; my suggestions are
 - requirement to base information on statistical model which is consistent with obvious facts, like level dependencies
 - requirement only to report numbers that are meaningful according to statistical model (e.g., returns over 3.25 yrs, not 1 yr, when dependency)
 - requirement that reported numbers be consistently estimated under model
 - requirement to revise views on investment, over time, in a way which is in accordance with the statistical model

Professionalism of bank vs customers

- In Fokus case, bank's defense was a balancing act:
 - On one hand, insisting that there was sufficient information in written material that customers should be able to infer important characteristics themselves
 - On the other hand, claiming that mistakes made by bank in written material was unimportant for customers' decisions, and should be ignored by courts
- In my opinion:
 - Admission of mistakes is insufficient; there were many more
 - Vis-a-vis non-professional customers, the question must be whether the total information picture is adequate
 - Vis-a-vis professional customers, the question must be whether information holds truly professional standards, and for these customers, any mistake can be decision critical
 - Difficult for courts to determine non-critical info v-a-v prof.s

Plaintiffs must suggest alternative information?

- In Fokus case, information given by bank was criticized for being insufficient and misleading
- In district court (the lowest of three), the lawyer of the plaintiffs was challenged to suggest alternative formulations of some part of info, and tried to do so
- Not particularly successful
- In my dissenting opinion, I state:

«Det er banken, og banken alene, som eventuelt må påta seg å gi en pedagogisk framstilling som både er forsvarlig og tilstrekkelig interessevekkende til at kundene er interesserte i å sette seg inn i den. Hvis dette ikke lar seg gjøre, må banken alternativt la være å markedsføre produktet overfor privatpersoner.»

(Ruling by Borgarting, 9.01.12, end of section 11.a, p. 120)

Plaintiffs must suggest alternative information?

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- In district court (the lowest of three), the lawyer of the plaintiffs was challenged to suggest alternative formulations of some part of info, and tried to do so
- Not particularly successful
- In my dissenting opinion, I state:

It is the bank, and the bank alone, who, in case, must undertake to give a pedagogical presentation which is both proper and sufficiently interest-arousing so that customers are interested in digesting it. If this is impossible, the bank must, alternatively, refrain from marketing the product to private individuals.

(Ruling by Borgarting, 9.01.12, end of section 11.a, p. 120, my translation)

Plaintiffs responsible for suggesting alternative info, contd.

- The majority disagrees:

«Flertallet er grunnleggende uenig med mindretallet» (meg, DL) «i at det kan konstateres ansvarsgrunnlag uten å konkretisere hvordan Fokus Bank skulle ha fremstilt produktet overfor kundene, for så å drøfte hvorfor unnlåtelsen av å oppfylle slike krav til informasjon er klanderverdig.»

(Ruling by Borgarting, 9.01.12, end of section 3, p. 44)

- But it is not at all obvious that such a pedagogical presentation of this complicated material is possible
- Since the SC does not comment on this paragraph of the ruling, I hope for new legislation or regulation at this point

Plaintiffs responsible for suggesting alternative info, contd.

- The majority disagrees:

The majority fundamentally disagrees with the minority (me, DL) that one can establish responsibility without spelling out how Fokus Bank should have presented the product to the customers, and then discussing why the failure to satisfy such demands on information is blameworthy.

(Ruling by Borgarting, 9.01.12, end of section 3, p. 44, my translation)

- But it is not at all obvious that such a pedagogical presentation of this complicated material is possible
- Since the SC does not comment on this paragraph of the ruling, I hope for new legislation or regulation at this point

Collective or individual lawsuits

- Lawsuits by large number (e.g., 80) bank customers may be only way for small customers to gather enough resources (lawyers, experts)
- Unfortunate in Fokus case: SC does not consider individual circumstances at all
 - Perhaps SC concentrates on bank's written information material since this is the only obviously common information material; although other evidence was presented in SC
 - SC seems to believe that customers had the facility to analyze and understand small print, and ignore other info, even if this at most is true for some of the customers
 - SC ignores blatantly unprofessional behavior by bank, when customer is first advised to establish flexible loan, then to use large part of it to invest in risky product (which should be only 10% of total portfolio according to other part of info)