The effect of competition in intermediaries

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Motivation

- In an environment of incomplete information, consumers must often rely on the actions and recommendations of financial intermediaries.

Conflict of interests

Motivation

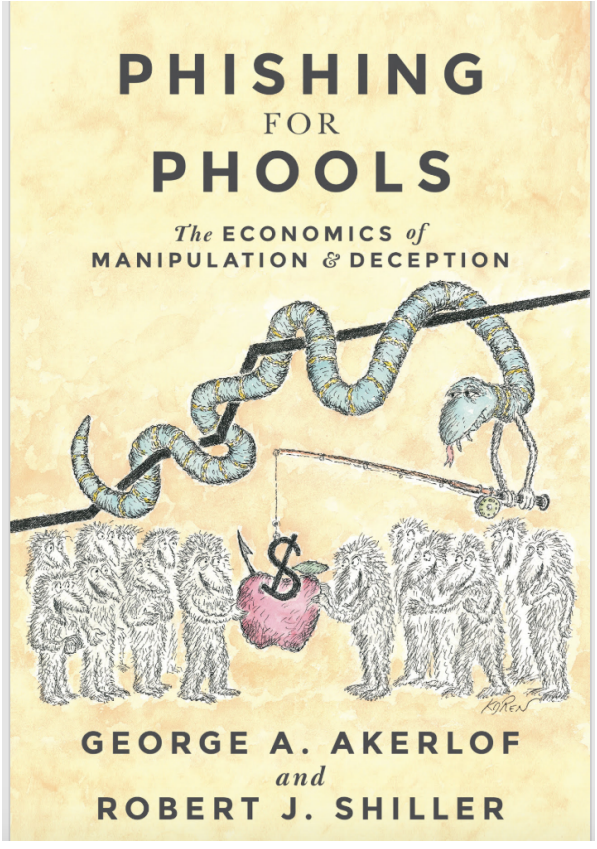
- Egan, et al. (2016) construct a novel database (FINRA) containing the universe of financial advisers in the United States from 2005 to 2015, representing approximately 10% of employment of the finance and insurance sector
  - Roughly 7% of advisers have engaged in misconduct
- Dimmock et al. (2018) identify using mergers of financial advisory firms in the period 1999-2011 that fraud is transmitted through career networks.

Motivation

- Parsons et al. (2018) find that
  - financial misconduct tends to disproportionately cluster in certain cities,
  - Geographic variation in social norms—informal understandings that govern a wide range of (mis)behaviors—accounts for a large part of these patterns
  - A city's social norms, as measured by other types of misbehavior, such as spousal infidelity or political corruption, strongly explain the geographic cross-section of FM.

Motivation

- Cohn et al.'s (2014): prevailing culture in banking favors dishonest behavior
- Akerlof and Shiller (2015): competitive markets create opportunities to profit from deception



Research Question

Does competition affect misconduct among financial intermediaries?

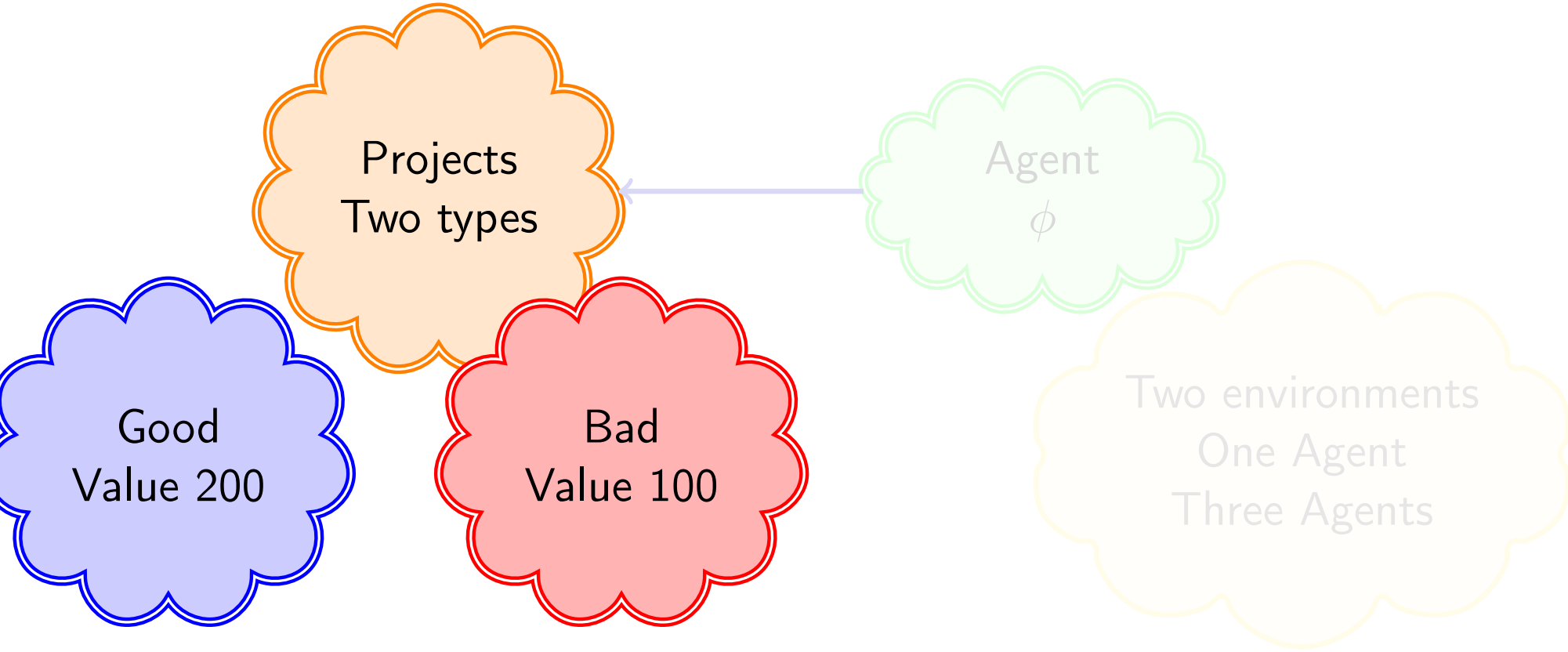
Principal and Agent model

- Delegated portfolio management
- Investors (principals) require the services of money-managers (agents) to process an investment in a one-shot game

The game

- Each Principal (P) has an initial endowment valued at 100
- An Agent (A) advises P on whether or not to proceed with the investment opportunity
- The projects (assets) are of two types, such that $\omega \in \{b, r\}$, where b designates a blue (high value) project and r designates a red (low value) project
- Both are equally likely to occur

The environment



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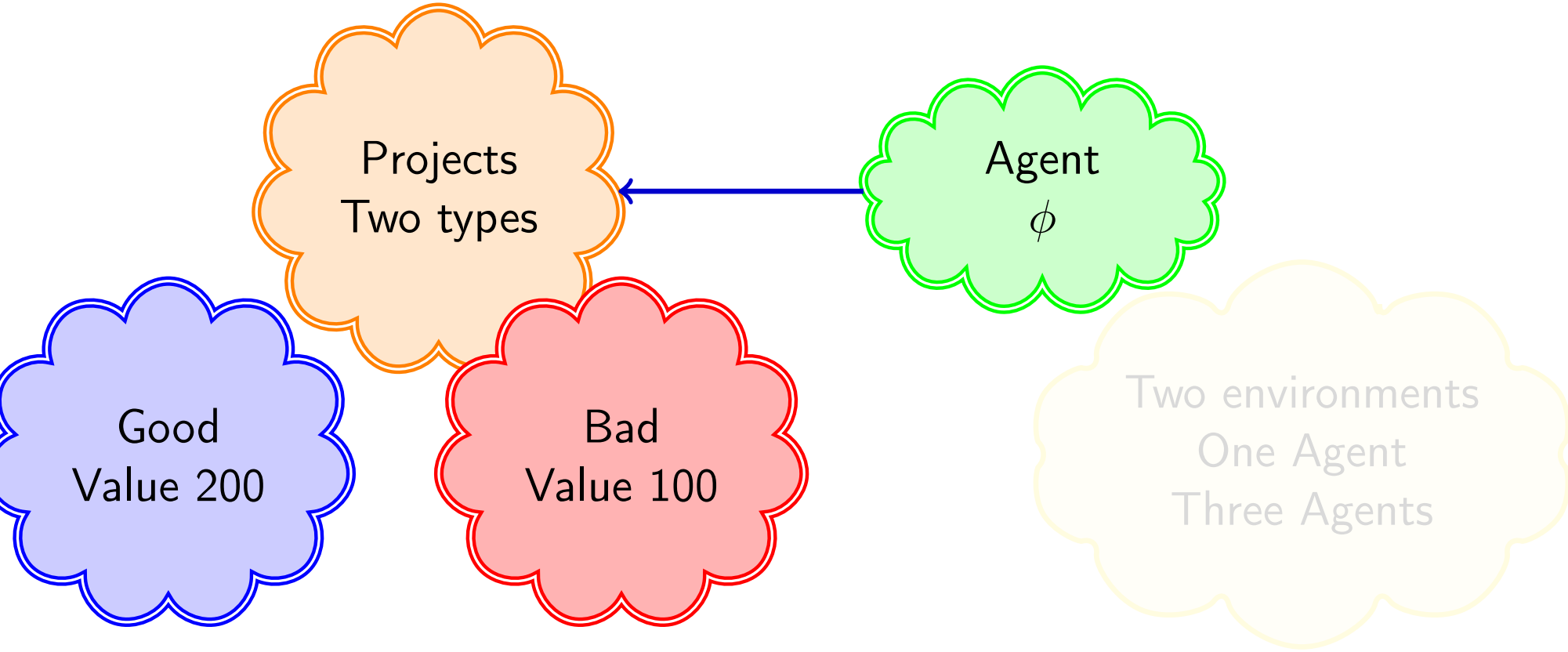

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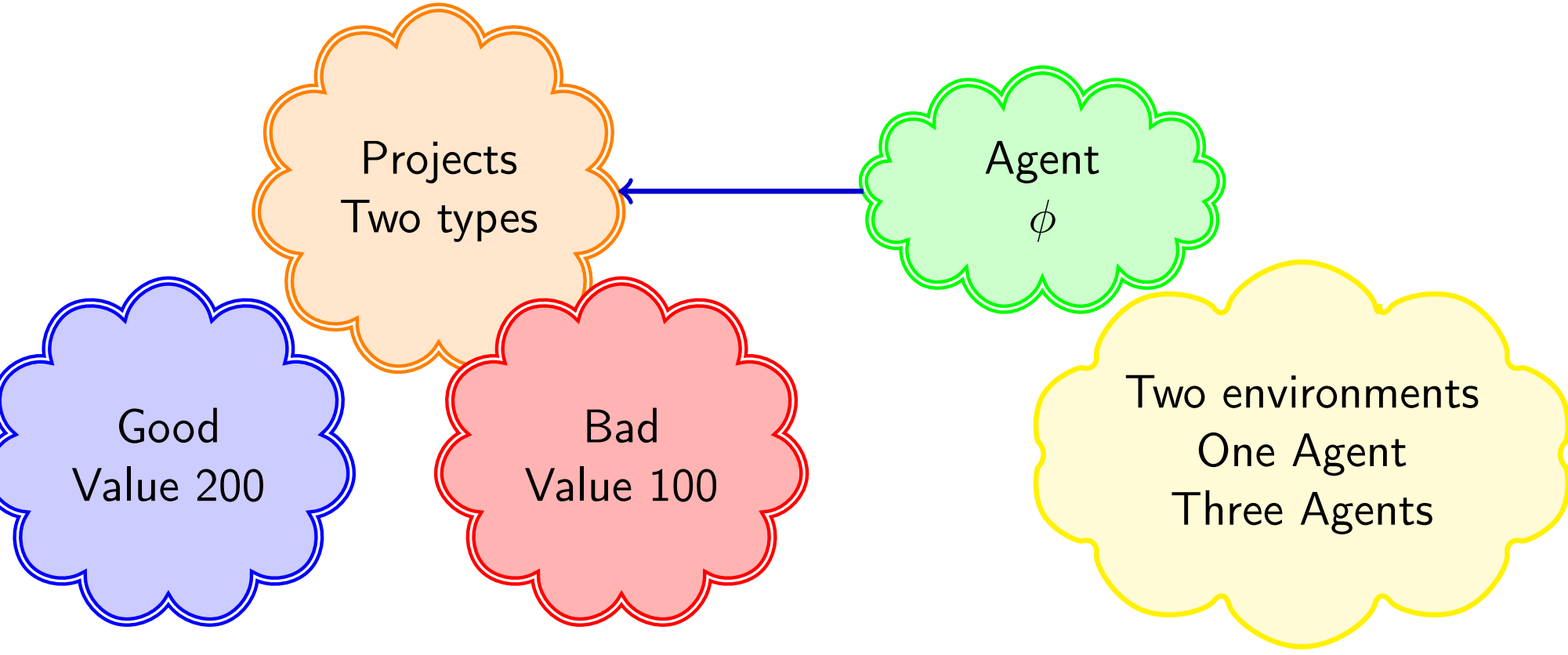
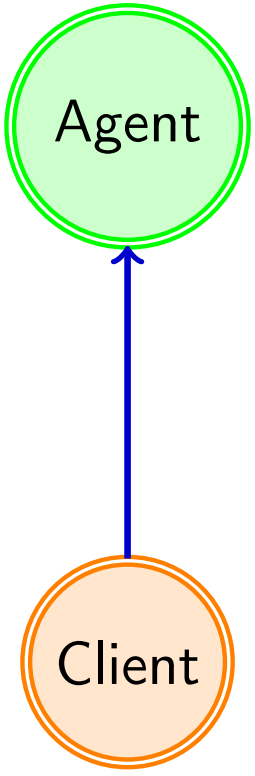


One Agent

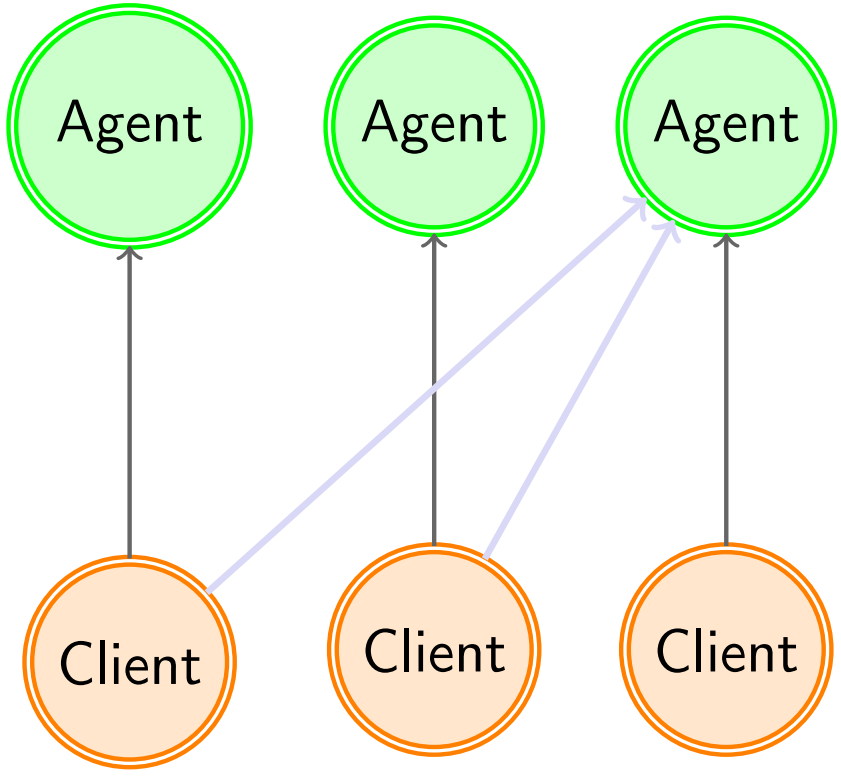
$$\pi^A = \begin{cases} 100 \times \phi & \text{if } a = c \\ 0 & \text{if } a = s \end{cases}$$

$$\pi^P = \begin{cases} 200 - \phi \times 100 & \text{if } a = c \text{ and } \omega = b \\ 100 - \phi \times 100 & \text{if } a = c \text{ and } \omega = r \\ 100 & \text{if } a = s \end{cases}$$



Three Agents

$$\pi^A = \begin{cases} 100 \times [\phi + \phi \times \frac{\text{A that s}}{\text{A that c}}] & \text{if } a = c \\ 0 & \text{if } a = s \end{cases}$$



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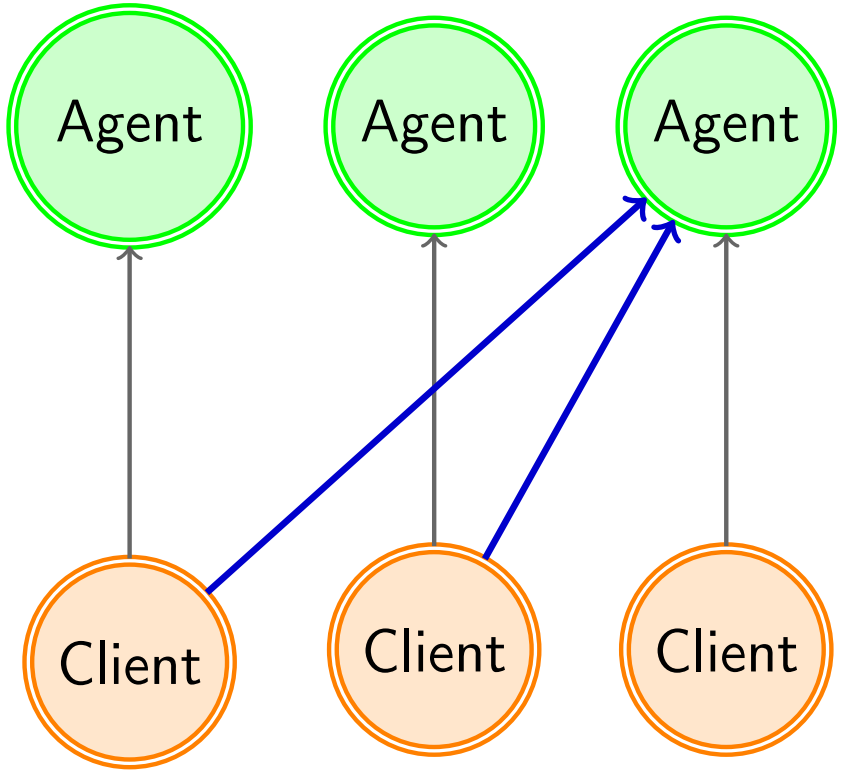

Results

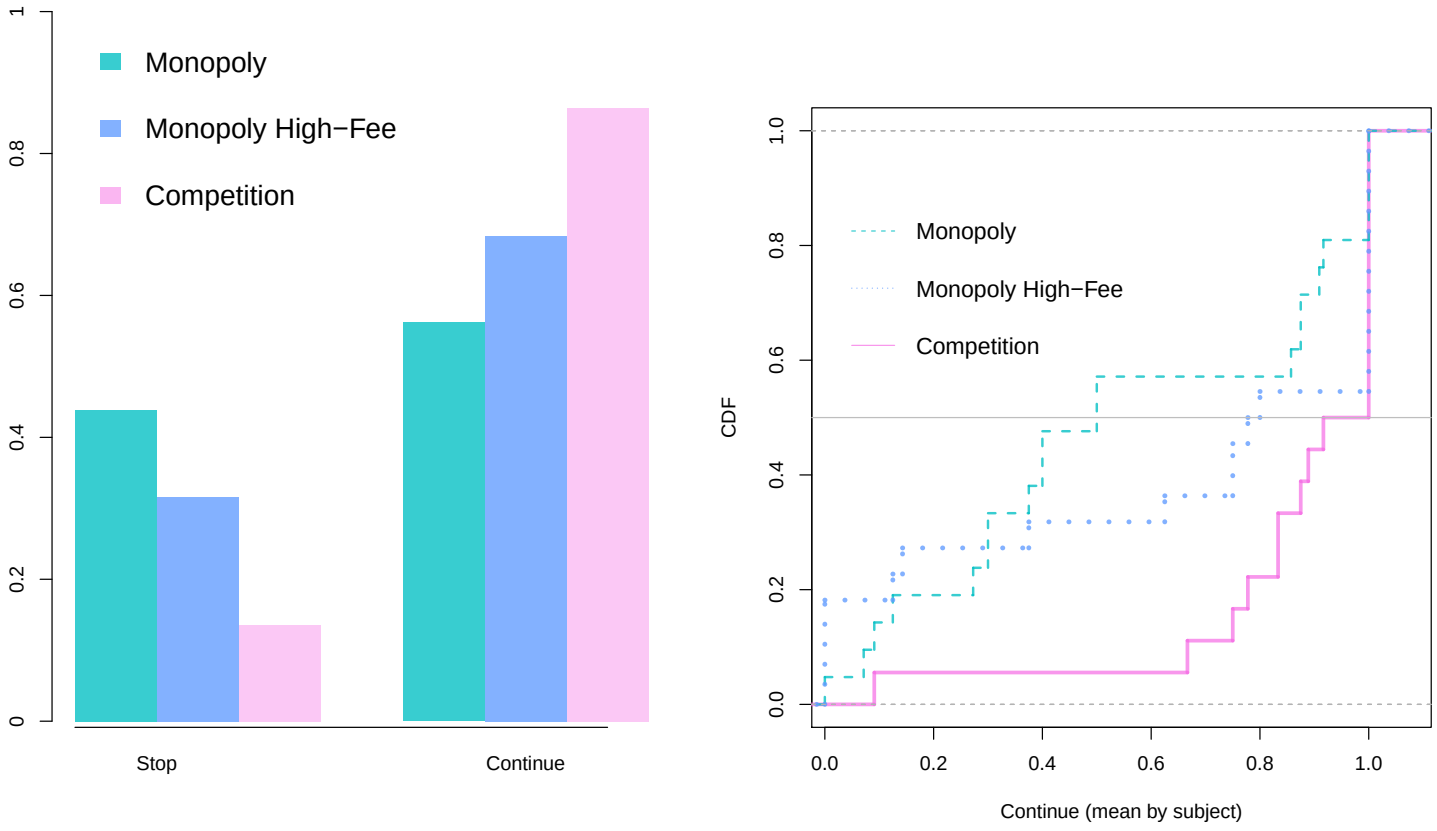

Figure: Agent choices when a red project is observed: (i) the left panel displays the fraction of continue/stop choices using pooled data and (ii) the right panel presents the CDF when agents choose continue using subject data (mean).

Discussion

- Most (if not all) prior experimental work find that competition does not harm market efficiency.
  - Due to reputational concerns (Huck et al. 2012; Dulleck et al. 2011)
  - Costly penalty costs (Rabanal and Rud, 2018) in an experiment with rating agencies.

Discussion (2)

- Can apply these finding to a number of P-A models: e.g. Ratings shopping in CRAs
- Dranove and Jin (JEL, 2010) discuss whether competition can mitigate the incentive problem by certifiers
  - Review of literature suggests that the role of competition is ambiguous
  - Contribution: isolate the role of competition

Thank you!

Comments at jeanpaul.rabanal@monash.edu

Table: Sessions overview

	Monopoly	Monopoly-High	Competition
N (of subjects)	21	22	36
Profit ($, mean per subject)	11.8	27.0	13.1
N (of sessions)	3	3	4
Continue when blue (mean)	0.99	0.98	0.99
Continue when red (mean)	0.56	0.68	0.86

Note: Profit includes a show-up fee of $5.

Results

Table: Decision to continue (logit)

	(I) All	(II) Red Only
Constant	0.93^{***}	0.87^{***}
	(0.02)	(0.04)
MT	-0.16^{***}	-0.29^{***}
	(0.05)	(0.08)
MHT	-0.10^{**}	-0.20^{**}
	(0.05)	(0.09)
Prob.$>$ Wald χ^2	0.00	0.00
N	1 580	754

The coefficients reported above are (i) the probability to continue for the constant and (ii) the marginal effects for MT and MHT. The logit estimation includes clustered standard errors at either session level (competition) or subject level (monopoly), using bootstrap.

*** $p \leq .01$, ** $p \leq .05$, * $p \leq .1$