

**Discussion of:**

**Legal Protection in Retail Financial Markets**

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- As title suggests, paper studies how laws should be designed to protect individuals in financial markets
- At a moment when government contemplated large reforms of financial regulation, hard to think of a more timely topic.
- Paper does an excellent job of analyzing one aspect of this problem
- Focus of paper: Many different agents may contribute to harm

# Many different agents may contribute to harm

- Main focus of paper: FI (financial institution) produces product, sold by broker
- Focus here on simple case:
  - outcome for each customer is either success ( $\bar{m}$ ) or failure ( $-\underline{m}$ )
  - model allows for third possibility of no sale
- Probability of failure is  $n_L$ , a function of effort choices  $e_1$  and  $e_2$ 
  - slightly different notation from in paper
- So social welfare is

$$\bar{m} - \overbrace{(\bar{m} + \underline{m})n_L}^{\text{cost of failure}}(e_1, e_2) - \overbrace{c_1(e_1) - c_2(e_2)}^{\text{effort cost functions}}$$

# Necessity of punitive damages for social first-best

- As authors observe, a moral-hazard-in-teams problem (Holmstrom 1982, see also Green 1976)
- Let  $s_i$  be share of cost of failure  $\bar{m} + \underline{m}$  imposed on contributing party  $i$
- Equilibrium condition (usual MC = MB)

$$\frac{\partial}{\partial e_i} c_i(e_i) = -s_i \cdot (\bar{m} + \underline{m}) \frac{\partial}{\partial e_i} n_L(e_1, e_2)$$

- Social welfare maximization condition (SMC = SMB)

$$\frac{\partial}{\partial e_i} c_i(e_i) = -(\bar{m} + \underline{m}) \frac{\partial}{\partial e_i} n_L(e_1, e_2)$$

- Appealingly simple optimal law:  $s_1 = s_2 = 1$ 
  - in paper's notation,  $\rho_A = \rho_F = \bar{m} + \underline{m}$
- In other words, strong form of what lawyers term *strict liability*: in case of harm, make both injurers compensate victim
- Qualitatively, victim is *more than made whole* (punitive damages)

# Important policy point

- Punitive damages often criticized (and even mocked)
  - famously, Stella Liebeck awarded \$2.7 million punitive damages for McDonalds coffee being too hot
- One justification for punitive damages is as correction for low probability of wrong being punished
- Paper gives another very convincing rationale: need to give incentives to multiple potential injurers

# Drawbacks to strict liability for each injurer

1. Costs as well as benefits from loss-reducing efforts:
  - in particular, more advice from broker makes purchasing product more time-consuming, and customers are lost to market
  - pushes penalty for broker below  $\bar{m} + \underline{m}$
  - (but qualitatively, still have punitive damages)
2. Punitive damages give customer the incentive to ignore the broker's advice and purchase wrong product (in expectation of punitive damages)
  - paper reanalyzes problem under alternative constraint of no punitive damages
  - can't get to social optimum (but see next slide)

# Getting to the social optimum

- Problem identified by paper is that punitive damages give customer incentive to ignore broker advice
- May be interesting to consider following potential solutions:
  1. Give damages to someone other than victim:  
Many states have split-awards statutes (“decoupling” in legal jargon)
  2. “Safe harbour” provision:  
Victim can’t sue if ignores broker’s advice
  3. Assess penalties at group rather than individual level:  
(From Holmstrom) If optimal efforts are  $e_1^*$  and  $e_2^*$ , impose penalties only if failure rate strictly exceeds  $n_L(e_1^*, e_2^*)$ .  
This gives an equilibrium with first-best effort levels, and now individual has no incentive to ignore advice.  
(Related, see also literature on avoiding need for budget-breaker)

# Another key feature of retail financial markets

- Hard to evaluate if FI and broker really at fault, as opposed to customer
  - e.g., who is to blame for bad mortgages?
- (There is a lot in paper already, so unfair to bring in more issues — *droit de discussant*)
- In a footnote, authors claim that doesn't matter if damages awarded wrongly because penalties can always be “appropriately scaled”
- Not so sure: imperfect awards necessitate larger damages for deterrence, but then:
  1. Large awards lead to socially wasteful influence activities in litigation (various papers on this, including one of my own)
  2. Imperfect award of damages has distributional consequences, which are surely important here
- Probably all topics for another paper ...

# Summary

- Very nice paper
- Sheds light on an important and timely question
- Main results of paper have clear and compelling economic intuition
- (not an easy combination to achieve)
- Punitive damages are not as bad as you might think (or industry representatives would have you believe)