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Financial standard products

Study into the effects of standard products on competition in the financial sector

Monitor Financial Sector
The Netherlands Authority for Consumers & Markets
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About the Monitor Financial Sector

The Monitor Financial Sector (*Monitor Financiële Sector*, MFS) is a part of the Netherlands Authority for Consumers & Markets (*Autoriteit Consument & Markt*, ACM). The MFS carries out studies into the degree and developments of competition in the Dutch financial industry.

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Executive summary

According to various stakeholders, financial standard products may promote competition in financial markets, as well as help consumers make better choices

Standard products are products with identical features (except price) that every provider in the market is required to offer. The features of the standard product are determined by the Ministry of Finance (hereafter: the ministry). The Commission on the Structure of Dutch Banks and other stakeholders believe that financial standard products help promote competition in the financial markets, in having consumers make socially desirable choices, and in reducing underconsumption as a result of choice overload.

Partly at the request of the ministry, ACM has conducted a study into the effects of a possible introduction of financial standard products

The ministry has asked the Netherlands Authority for Consumers and Markets (ACM) to conduct a study into the opportunities and risks of standard products the functioning of financial markets. The possible presence of market failures may prevent the market from reaching a welfare optimum on its own. The presence of market failures may thus be a reason for government intervention. Without concluding anything about whether such market failures exist in the financial sector, ACM has assessed to what extent market failures are reduced by the introduction of standard products. The emphasis of ACM's study is on the market failure 'market power,' or to what extent standard products help improve competition. The study has been a theoretical analysis because the market failures have not yet sufficiently been proven in practice, and because there is not enough empirical data about the effects of introducing standard products. In order to be able to conclude anything about the likely effects, several assumptions have been made.

It does not seem plausible that the introduction of standard products will increase competition in financial markets

Based on the analysis, it does not seem likely that standard products will increase competition in financial markets. There is a risk that providers decide, independently from each other, to minimize the sales of the standard product. In that case, standard products are likely to have a marginal effect on competition, and the providers will continue their business as usual. Even if providers do decide to offer the standard product actively and competitively, no unequivocally positive effect on the level of competition in the entire market can be expected. By increasing the product range, mutual competition may increase, but consumers will also have to compare more products, which makes them less price-sensitive. In that case, the overall effect depends on the specific market circumstances, and which of the two previous effects will dominate.

Other government measures appear better suited to improve consumer choice behavior

Standard products do not appear to reduce the other relevant market failures directly either (information asymmetry, externalities, and non-rational choice behavior). However, standard products may limit the effects of these market failures such as underconsumption, but this, too, would result in a disruption in the process of consumer choice behavior. For example, it will be possible that

consumers will solely focus on the standard product, while a different product would be more suited for their situation. Therefore, measures that are directly aimed at resolving market failures appear more appropriate. Examples are simplifying and standardizing product information or introducing tax incentives in order to have consumers purchase a certain product (or product variety).

ACM recommends the ministry to carry out additional empirical studies before deciding to introduce standard products

ACM comes to the conclusion that the introduction of standard products will not likely lead to increased competition or to a reduction of other market failures. If the ministry decides to further develop the concept of standard products, ACM then recommends additional empirical studies be conducted first. Such studies should, among other findings, confirm the existence of market failures in the real world, and demonstrate that the introduction of standard products is the most efficient and effective form of government intervention to tackle these market failures.

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Contents

1 Introduction

In its final report, the Commission on the Structure of Dutch Banks (2013) makes the recommendation that "(…) *banks must be obliged to offer a standard variety of complicated financial products that have a substantial and long-term impact on households.*" The Dutch Ministry of Finance (hereafter: ministry) subsequently asked the Netherlands Authority for Consumers and Markets (hereafter: ACM) to carry out a study into the "(…) opportunities and risks of standard products to competition[1] in the various financial submarkets[2,3]."

1.1 Objective of the study

The ministry names three goals that financial standard products can potentially realize. These can be summarized as:[4]

(i) Promoting competition;
(ii) Steering choice behavior in a socially desired direction;
(iii) Reducing underconsumption as a result of choice overload.

These goals imply there are three different problems: (1) insufficient competition, (2) undesirable product choices (socially undesirable or otherwise), and (3) underconsumption as a result of choice overload. The existence of these three problems in different financial submarkets has, in practice, insufficiently been determined, and does not fall under the scope of this study.

For this study, it is assumed that the abovementioned presumed problems do exist. The objective of this study is to analyze whether standard products can help reduce these problems. The emphasis is on the potential effects of the introduction of standard products on the level of competition. In this study, this is done theoretically in part because of the lack of sufficient empirical information. In addition, ACM believes that any empirical study (of its own or otherwise) has more added value if such is preceded by a solid theoretical foundation.

1.2 Financial standard products defined

The report of the Commission on the Structure of Dutch Banks as well as the subsequent debates in the Dutch House of Representatives do not provide a clear definition of financial standard products. However, such a definition is necessary to be able to estimate the effects of standard products. In consultation with the ministry, ACM has drawn up the following definition of standard products:

> "*A standard product is a financial product of which all features, except price, are the same among all providers, and which all providers on the product market in question must offer, but is not presented to consumers as the default product.*"

[1] The functioning of a market is influenced by the structure of the supply side, the behavior of buyers, and the way suppliers compete with one another.

[2] Dutch Ministry of Finance (2014).

[3] At the request of the ministry, the Netherlands Authority for the Financial Markets (AFM) conducted a study into the effects of standard products on consumer choice behavior.

[4] Dutch Ministry of Finance (2014).

1.3 Structure of this report

The structure of this report is as follows. First, it is explained how ACM set up this study into the effects of standard products, and what theoretical framework was used. Chapter 3 discusses the question of whether standard products are able to reduce the market failure 'market power', and whether this leads to more competition. Chapter 4 looks at the other market failures, exploring whether standard products are able to help reduce information asymmetry, externalities or non-rational choice behavior, and, thus, is able to help consumers in making desirable choices (socially desirable or otherwise), and to help reduce underconsumption. Chapter 5 concludes.

2 Theoretical framework

Introducing standard products is a form of government intervention. The government can have different reasons for intervening in a market. One key motivation is if the market is unable to reach a welfare optimum[5] by itself[6]. This is then considered a *market failure*.[7] With the introduction of standard products, the ministry, as described earlier, aims to address three possible problems, which are:

1. Insufficient competition with regard to financial products (certain products);
2. Purchase of undesirable products (socially undesirable or otherwise) by consumers;
3. Underconsumption as a result of stress of choice.

According to ACM, the causes of these problems may lie in the existence of market failures. These are widely recognized market conditions in which a welfare optimum is not reached.[8] If the market fails, government intervention is justified, on the condition that the 'benefits' resulting from the intervention outweigh the 'costs' of the government intervention.[9]

Four 'classic' forms of market failure can be identified, which are *market power,*

Box 1: Market failures

Below is a brief description of the various market failures:

i) Market power

Market power is the extent to which providers (or a group thereof) are able to operate independently of its competitors. With market power, providers are able to sustainably charge prices above competitive levels, resulting in an inefficient allocation of production resources.

ii) Information asymmetry

Information asymmetry means that one party has more information than does another party. This difference in information between parties creates a risk for opportunistic behavior, and, by extension, suboptimal choices and outcomes.

iii) Externalities

Externalities arise when the consumption or production of a good or service results in benefits or costs for others. This may lead to inefficient outcomes if economic agents insufficiently (or fail to) take into account these externalities in their decision-making process.

iv) Public goods

A good is considered a public good if, after production, no one can be excluded from using that good, and where the use thereof by one individual does not come at the expense of the use thereof by another. Good examples of public goods are dikes and national defense.

v) Non-rational choices

In the real world, consumers do not always act completely rationally. That is because, when making choices, they are sometimes influenced by *biases*. In addition, consumers have in practice a limited amount of time, motivation, and intelligence to make choices, as a result of which they use rules of thumb (heuristics).

[5] In this report, 'welfare' is defined as the sum of the consumer surplus and the producer surplus in a market. It is therefore an economic interpretation of the concept of welfare.

[6] De Bijl & Van Damme (1997).

[7] In addition, the government may wish to redistribute income between groups of consumers in a manner that is desired by the government.

[8] If the market fails, the Pareto-optimum is not reached. A market is Pareto-efficient when no one can be made better off without making someone else worse off.

[9] Donders & Gradus (2012), p.36.

information asymmetry, externalities and public goods.[10] The market failure of public goods will not be discussed any further in this study, because, as far as is known, this is not an issue in financial products.[11] Nowadays, *non-rational choice behavior* is considered a fifth form of market failure (See Box 1 for an explanation).

By linking the problems presumed by the ministry with the different forms of market failure, a clear framework emerges in which the effects of standard products on the markets can be analyzed. If standard products fail to solve or reduce the market failures, then a clear justification for that form of government intervention is lacking. Below is a table in which it is described how the market failures may cause the problems presumed by the ministry.

Table 1: Direct relationship between market failure and the presumed problems

	Insufficient competition	Undesirable product choices (socially or otherwise)	Underconsumption through choice overload
Market power	X		
Externalities		X	X
Information asymmetry		X	X
Non-rational choice behavior		X	X

Problem 1: There is insufficient competition on financial markets (or certain markets)

The market failure 'market power' is a direct cause of insufficient competition. Insufficient competition can also be caused indirectly by the market failures 'information asymmetry' and 'non-rational choice behavior.' Information asymmetry may lead to higher search costs for consumers, while non-rational choice behavior may lead to higher switching costs for consumers. These increased search and switching costs result in providers gaining market power, and thus indirectly result in a situation of insufficient competition. Chapter 3 will discuss this in greater detail.

Problem 2: Consumers purchase undesirable products (socially or otherwise undesirable)

Three market failures may lead to consumers purchasing undesirable products (socially undesirable of otherwise). First, information asymmetry can be a cause. Information asymmetry can be caused, for example, by providers withholding specific information about the product, which is what happened with the controversial investment-linked life insurances (popularly called '*woekerpolissen*' in Dutch).[12] Consumers thus purchased undesirable products. Second, externalities can be a cause, too. It would be better, not for the consumer as an individual, but for society at large, if the consumer purchased a different product variety. Finally, non-rational choice behavior, too, can result in consumers purchasing undesirable products. Biases in preferences or heuristics may result in consumers purchasing undesirable products.

[10] Pindyck & Rubinfeld (2005).

[11] Financial products do not meet the criteria of non-exclusivity and non-rivalry.

[12] AFM (2008), p.5.

Problem 3: Choice overload causes underconsumption

Underconsumption can result from choice overload, and, in turn, choice overload can be caused by various market failures. First, information asymmetry can cause underconsumption. If a consumer knows he has less information than the provider, he might be more inclined to believe that, as a result thereof, he is more likely to make the wrong product choice. This can lead to choice overload, thereby causing underconsumption.[13] Second, non-rational choice behavior, too, can lead to underconsumption. For example, if consumers feel that they get too much information, it becomes more difficult to really understand and compare the products. This information overload can lead to consumers delaying their product choices.[14] Finally, externalities can also cause underconsumption, though not through the mechanism of choice overload. In this case, it would be better, not for the consumer as an individual, but for society at large, if the consumer purchased a financial product. Since an individual consumer does not take into consideration the positive externalities, underconsumption may arise in society at large.

Box 2: The providers' duty of care

Since 2014, providers of financial products are statutorily required to act in the customer's interest. This means that, among other things, sold financial products must meet the needs of the customer. AFM enforces compliance with this duty of care. The duty of care acts as an incentive for providers to sell consumers products that meet their preference.

One of the reasons of introducing standard products is to prevent consumers from purchasing undesirable products (socially undesirable or otherwise). It could be questioned whether the current duty of care does not already solve this problem.

The above explains that, in theory, market failures can cause the presumed problems. The question now is whether standard products are an effective instrument for resolving or reducing the individual market failures. If such is the case, it can be examined whether it is the most efficient way of intervening. That is why the main research question of this study is:

To what extent do standard products help resolve/reduce market failures in financial markets?

2.1 Assumptions of the theoretical study

Making certain assumptions is critical in order to be able to analyze the effects of introducing standard products. These assumptions relate to the standard product, and to the way providers and consumers respond to the introduction of a standard product.

Assumptions about providers

With regard to the providers, the most important assumption is that they are required to offer the standard product in addition to their current product range. The introduction of the standard product thus, at first, leads to more products on the market. As a result, these providers will also incur

[13] A sense of responsibility can be one of the reasons of choice overload (Iyengar & Lepper (2000), p.1000.)

[14] Oxera (2013), p.13.

additional fixed costs. The fixed costs of the standard product may be lower than those for non-standard products, because it is developed by the government.

In the long term, a dynamic effect may occur. The introduction of standard products may lead to fewer product varieties on the market, as products are withdrawn from the market. This is caused by reduced demand for non-standard products, and, as a consequence, the declining profitability of these products. However, since such dynamic effects are highly uncertain, this study will only take into account the first initial effect, where the standard product leads to an increase in the product range.

Assumptions about consumer choice behavior

Economic theory often assumes the *homo economicus*. This is a consumer who, based on all available information, weighs costs and benefits, and then makes a rational choice, maximizing his individual welfare. However, consumers do not always make rational choices in reality. The level of non-rational choice behavior varies per consumer and per situation.

ACM distinguishes three forms of non-rational choice behavior. First, consumer preferences can be context-dependent such as the *biases reference dependence* and *loss aversion*. This means, for example, that the way information is presented has an effect on consumer preferences.[15] Second, consumers sometimes have incorrect assumptions of their future needs. As a result, they make choices that are inconsistent over time (*time inconsistency*).[16] Third, consumers sometimes unconsciously use rules of thumb (or *heuristics*) when making decisions. The use of heuristics follows from the fact that, in reality, consumers have a limited amount of time, motivation, and cognitive capabilities. By using heuristics, consumers are able to save time and effort. One example is that consumers let experiences determine their choices, or that they make a choice, while knowing that other consumers have made the same choice. However, by using heuristics, consumers, under certain conditions, make mistakes in the choice process.

As a result of non-rational choice behavior, ACM believes it is plausible that consumers are influenced by the standard product in two ways. First, certain consumers are more likely to purchase the standard product, even though it does not match their preferences.[17] This is because the government has designed this product. It is as if the standard product is government-certified (some sort of seal of approval). As a result, some consumers may attribute a higher quality (real or perceived) to the standard product in comparison with non-standard products.

Second, ACM believes it is also possible that consumers are led by the standard product in their search behavior. Various studies reveal that consumers base their behavior around an *anchor*.[18] The

[15] Oxera (2013), p.10

[16] O'Donoghue & Rabin (1999).

[17] When making difficult choices, consumers may decide to delay making their choice, or decide to go for the 'recommended' option directly. The standard product is possibly this 'recommended' option (Oxera (2013), p.13).

[18] Furnham & Boo (2011).

standard product could serve as such an anchor, where consumers use the standard product as the starting point for their search. This is particularly true for those product features some consumers have incomplete preferential knowledge of, and with regard to which there is a certain order (for example higher or lower mortgage pay-off amounts without any penalty, or more or less risk). As a result, some consumers may thus be more likely to end up with products that are similar to the standard product. This partly looks like the previous effect, but the difference is that, in this case, the consumer does not necessarily assume that the standard product is better than the other products.

There is uncertainty over to what extent the two abovementioned effects actually exist in the real world, and to what market outcomes they lead. The field of literature that looks into this, which is behavioral industrial organization, is actually still relatively new, and is still in its infancy. These assumptions should thus be further examined (empirically), if it were decided to introduce standard products. However, ACM does believe that these assumptions are sufficiently plausible, and therefore they will be used in the rest of this study.

Box 3: How realistic is the assumption of heterogeneous preferences?

The assumption of demand heterogeneity may seem unrealistic when looking at certain financial markets such as insurance markets. For example, when looking at personal property insurances, more coverage always seems the better option for all consumers. However, increased coverage also means higher costs, which means that, *ceteris paribus*, increased coverage also leads to a higher price. That, combined with the fact that consumers attach different values to increased coverage, means that there is an optimal coverage for each consumer after all. So more is not always better. As a result, consumer demand in insurance markets may well be considered to be heterogeneous.

Demand heterogeneity

Finally, ACM assumes demand heterogeneity. This means that consumers are different, and thus have different preferences (including in products). ACM believes it is plausible that consumers have different demand preferences with regard to financial products, just like they can have preferences with regard to the color of their cars.[19] For example, the degree of risk aversion may differ, which has implications for the risks that consumers are willing to take when buying, for example, an investment product or when choosing the period for a fixed-rate mortgage. It is important to note that this means there are not any choices that are better (or worse). With different consumer preferences, it is best that consumers buy different products. Therefore, there is no clear order where one specific product is better than the other for everyone. One logical consequence is that it is assumed that the quality (at least the vertical quality) of the yet-to-be-introduced standard product is equal to the quality of existing products in the market.[20]

[19] In this study, the possibility of preference homogeneity is not completely ignored. Box 7 looks at the situation where preferences are more homogeneous, and to what extent this changes the outcome of the analysis.

[20] Horizontal differentiation means that if product A and product B are offered at exactly the same price, some consumers buy product A, and others buy product B. The difference in the product actually bought can be explained by the preferences of consumers. The opposite is vertical differentiation, which means that product A and product B differ from each other, but if they are sold at the exact same price, all consumers choose product A. Product A thus has a higher vertical quality than product B.

3 Standard products and market power

Market power is a direct cause of insufficient competition in financial market. This chapter looks at the question of whether standard products are able to reduce market power. Market power can stem from different sources. Sources that are known in the literature are:

- Coordination
- Product differentiation
- Search costs
- Switching costs
- Barriers to entry
- Bundling/tying
- Capacity restrictions
- Economies of scale
- Licenses/patents

For each source of market power, ACM analyzed whether, in theory, it is affected by standard products. For several sources, this is not plausible.[21] The analysis has therefore been limited to sources of market power that, in theory, are affected by standard products. These are coordination (part 3.1), product differentiation (part 3.2), search costs (part 3.3), switching costs (part 3.4) and barriers to entry (part 3.5).

It is thus implicitly assumed that the abovementioned five sources of market power actually exist in the market in order to subsequently argue in what way standard products affect these. In reality however, it needs to be established first that the source of market power actually exists in the market. In order to do so, the relevant market needs to be defined first, among other things (see Box 4).

Box 4: Defining the relevant market

Introducing standard products raises the fundamental question of what providers should offer this product. In order to answer this question, the relevant market needs to be defined. As perceived by consumers, are, for example, annuities and tax-free savings accounts (with banks) substitutes of each other?

Too narrow a definition of the relevant market could disrupt competition between providers of different products. For example, the introduction of a standard tax-free savings account could lead to reduced demand for annuities, thus favoring the providers of standard tax-free savings accounts. This is the result of an improper competitive advantage that providers of standard tax-free savings accounts obtain through the standard product.

The introduction of standard products can also disrupt competition within relevant markets. Imagine a standard product which shares more similarities with the current product of provider A than the one of provider B. The potential shift in demand from the products of A and B to the standard product would result in provider A losing more sales than provider B because provider B offsets part of his losses with the standard product.

3.1 Coordination as a source of market power

Providers are able to jointly increase their market power by raising prices through coordination. This

[21] A banking license, for example, is not obtained more easily as a result of the introduction of standard products. In addition, tying, in principle, does not become easier or more difficult. Furthermore, any capacity restrictions are not affected by standard products, because banks would then not be able to attract capital more easily. Finally, standard products are not expected to have more or fewer economies of scale than non-standard products.

can be done both explicitly and tacitly.[22] Explicit coordination means that providers jointly decide (concretely and through direct communication), for example, what the market price will be or how the market will be divided. This form of coordination is prohibited under Section 6 of the Dutch Competition Act, and ACM considers it not likely that providers will coordinate in this manner as a result of the standard product.

However, providers are also able to coordinate tacitly. This form of coordination is more difficult to organize and to maintain, and is often only set up in markets with a limited number of providers (oligopolistic markets).[23] With tacit coordination, direct cooperation does not exist like with explicit coordination. That is because providers purely act in their own interests, and not in the common interest of the cartel. Providers thus maximize their profits by taking into account the interdependence of competitors. This can lead to individual decisions of providers to raise prices or not to lower them further, because, in the long run, it would lead to lower profits. The coordinating providers thus increase their individual profits. This form of coordination – or parallel market behavior – is not prohibited by law, but does reduce welfare compared with perfect competition.

3.1.1 Coordination incentives and opportunities with regard to standard products

Providers are required to offer the standard product, but may have an incentive to tacitly coordinate their market behavior with regard to the standard product. According to ACM, this may manifest itself in independent decisions by providers to minimize the sales of the standard product, thereby continuing business as usual.[24] This can be realized, for example, by charging a higher price for the standard product or by discouraging consumers in sales pitches from buying the standard product. ACM thinks it is plausible that the incentive and opportunity for tacit coordination is greater with the standard product than with non-standard products. This has several reasons.

First, it is easier for providers to monitor their competitors' market behavior.[25] After all, because of the

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[22] For stable coordination, at least the following three cumulative conditions must be met (Airtours-criteria (Case T-342/99 Airtours v. Commission)):

1. The providers must agree on their behavior, which leads to higher profits for each provider than in a situation without coordination;
2. The coordination must be sustainable, which means that providers are able to monitor each other's behavior, and that they have a credible deterrent mechanism;
3. The coordination cannot be jeopardized by external factors such as entry or buyer power.

[23] This is because an individual provider can influence the market price in a market with a limited number of providers. Conversely, an individual provider in a competitive market is a price taker.

[24] Coordination may also manifest itself in charging the monopoly price for standard products. Since the developments and trends of standard products are heavily monitored by lawmakers and government officials, it is more difficult to maintain the monopoly price than to minimize the sales of standard products.

[25] Apart from the fact that monitoring becomes easier, it also means that it becomes easier for consumers to compare standard products. With regard to these conflicting effects, refer, for example, to the discussion on transparency in fuel prices at gas stations along highways. (OECD (2013), p.19).

homogeneity of standard products[26], providers only need to check the changes in prices rather than changes in product features.[27] Second, providers have an incentive to prevent competition on the standard product because of this homogeneity. According to economic theory, perfect competition on homogeneous products leads to a price equal to marginal costs, and thus to limited profits. If the standard product diverts demand from non-standard products to itself, the provider's total profits decrease. From this point of view, it is therefore attractive for providers to limit the sales of the standard product.[28]

Tacit coordination can possibly be broken by new entrants. Entry is possibly easier because a new entrant may choose to enter the market with only the standard product. This might be easier than entry in the current situation, because the entrant incurs fewer product development costs. In addition, the entrant is able to gain market share faster, because the other providers do not offer the standard product attractively. However, ACM does not consider this entry scenario plausible. After all, this kind of entry is noticed very fast. The incumbent providers will then soon decide to compete on the standard product. The expected profits that a potential entrant can earn with this type of entry will thus be relatively low, particularly if he is not more efficient than his competitors. As a potential entrant takes into account the limited profitability of entry, it becomes less likely that he will enter the market this way.[29]

3.1.2 Interim conclusion regarding tacit coordination

Providers are required to offer the standard product, but they can decide to tacitly coordinate their market behavior. This may result in the independent decisions of providers to minimize the sales of the standard product. This type of coordination is more likely to occur with standard products than with other products, because the behavior of competitors is more easily monitored, and because providers may wish to prevent competition on the standard product, as it may lead to substantially lower profits.

It is difficult to predict in advance to what extent providers will actually minimize the sales of the

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[26] Ivaldi et al. (2003), p.47.

[27] Ivaldi et al. (2003), p.22.

[28] On the other hand, if one provider decided to lower its price, it could also lead to an enormous sales increase, and thus to higher profits for this provider. However, since it is more likely that this is noticed by competitors, and because the sales increase is limited due to the long-term nature (which is often the case) of financial products, this increase in profits may be limited. At the same time, it is likely that it will lead to competition on the standard product. Total profits in the long run may thus decrease even more severely than the additional profits in the short term, thereby removing the incentive for providers to increase sales of the standard product (Edwards (1955); Bernheim & Whinston (1990), p.1 and Ivaldi et al. (2003), p.48).

[29] It is of course also possible that a provider enters the market, makes a profit in a short amount of time by offering the standard product very attractively, and then exits the market when the incumbent providers decide to compete on the standard product. This hit-and-run strategy (or the threat thereof) is only credible if the sunk costs on entry are low. A previous study by ACM (2014) into the barriers to entry in the Dutch retail banking sector has revealed there are significant barriers to entry in the Dutch financial sector.

standard product. However, this can be of influence on the degree to which total market power is restricted as a result of the introduction of standard products. In the case of tacit coordination, the providers continue to do business as usual. This means that the introduction of standard products will hardly have any effect on competition.

3.2 Product differentiation as a source of market power

Product differentiation is a way for providers to differentiate themselves from competitors.[30] Generally speaking, consumers have heterogeneous preferences, and are thus prepared to pay more for one product than for the other. They will only buy a different product if the price difference is large enough to compensate them for the fact that they will get a product that fits less (in their perception at least). Deviating from the preferred option thus carries 'costs' for consumers.

Box 5: Salop's circular model

For product differentiation, the economic literature primarily uses *Hotelling's location model*[25] or *Salop's circular model*[26] (see Figure 1). These models assume that consumers are evenly dispersed along a horizontal line (Hotelling) or on the edge of a circle (Salop). The location of any individual consumer on the circle reflects his product preferences. Providers then choose a spot on the circle to position their product in the market. Since an offered product can only occupy a single spot on the circle, and because consumers are evenly dispersed along it, the offered product is never able to fully satisfy the needs of all consumers. Consumers subsequently have to incur 'costs' when moving from their location to the spot of the provider's product. These are the costs to deviate from the optimal design of the product (in the eyes of the individual consumer). Based on a combination of price and costs, consumers then decide to deviate from their preferences for the product that fits best.

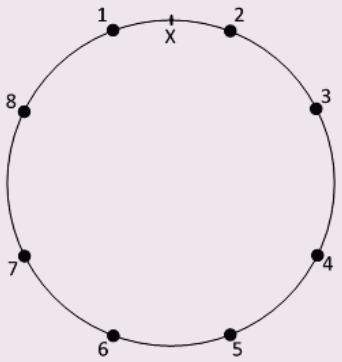

Figure 1: Example of a Salop circle with eight providers. Consumer X is an example of a consumer for whom the products of providers 1 and 2 relatively match his preferences well, and those of providers 5 and 6 completely not.

Product differentiation gives providers market power over consumers who, in terms of their product preferences, are close to the product of the provider. The less substitutable products are as perceived by consumers, the greater the provider's market power is over these consumers.

3.2.1 Effects of the standard product on product differentiation

The introduction of the standard product results in an additional (and competing) product variety entering the market. In the

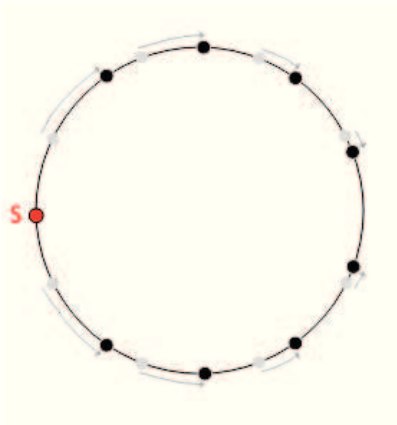

Figure 2: To escape from the disciplining effect of the standard product, providers have an incentive to make their non-standard products less similar to the standard product. As a result, they move closer to one another.

[30] Chamberlin (1933).

Salop model (see Box 5), this results in a reduction of the average distance between providers (consumers have more substitution options) and in a reduction of the level of market power in the entire market. It is also conceivable that providers will reposition the non-standard products after the introduction of the standard product. This depends on the strength of the incentive to make the non-standard products look more like the standard product or less like the standard product.

Competition on the standard product has a disciplining effect on non-standard products. A relatively low price of the standard product means that the prices of non-standard products that strongly resemble the standard product must also go down in order to remain competitive. The lower price of these non-standard products, in their turn, disciplines other non-standard products, which leads to lower prices in the entire market through a kind of domino effect.[31] However, in that process, it remains to be seen how strong the mutual disciplining effect is. In a market with limited transparency, which certain financial markets may be considered as such, consumers may find it hard to discern the quality differences, thus rendering the disciplining effect rather limited.

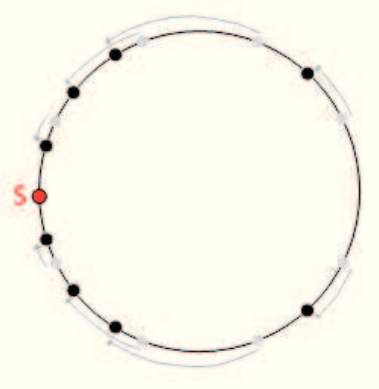

Figure 3: In case of an increase in demand around the standard product, providers may have an incentive to make their non-standard products look more like the standard product.

If this disciplining effect does occur, it may give providers an incentive to have non-standard products look less like the standard product in order to escape the disciplining effect (see Figure 2). However, the incentive to differentiate is somewhat limited, because, if all providers did so, the mutual disciplining effect between non-standard products would increase again. Thus, the ability of providers to escape the disciplining effect of the standard product is rather limited.

On the other hand, consumers could use the standard product as the starting point in their search for the right financial product. This increases the likelihood that these consumers choose a product that resembles the standard product. Demand around the standard product may thus increase at the expense of demand in the rest of the market. This shift in demand gives providers an incentive to make their non-standard products look more like the standard product (see Figure 3).

The strength of each of these two conflicting incentives to reposition the non-standard products depends on the way consumers react to the introduction of the standard product. For example, the more consumers perceive the standard product as qualitatively better than the non-standard products, the stronger the incentive is to have the non-standard products look less like the standard product. After all, the non-standard products that are close to the standard product need to compensate this perceived higher quality with a lower price. The more consumers use the standard product as a starting point in their search, the stronger the incentive is to have the non-standard products look more like the standard product. After all, it is more likely that these consumers will purchase a product that looks like the standard product, allowing a provider to increase its sales by

[31] Atkinson et al. (2009, p.585), Chamberlin (1933) and Rothschild (1982).

making its product resemble the standard product.

This repositioning may lead to a redistribution of the market power over consumers (which is lower on average). This depends on the way providers reposition the non-standard products, on the level of transparency, and thus on the mutual disciplining effect. For example, the market power on some non-standard products could increase if a lot of providers decided to reposition their products around the standard product (the providers on the right side of Figure 3).

3.3 Search costs as a source of market power

If consumers have incomplete information about the product offerings in the market, they incur search costs. Search costs can be divided into external and internal costs.[32] External search costs consist of the time that consumers must invest in the search and selection process, and any costs that are incurred in order to purchase information. Internal search costs are the mental efforts that consumers must put in to understand and analyze the information.

Consumers will include an additional provider in their search process if the marginal search costs to find information about this provider are lower than the probability that this provider offers a product that is cheaper or matches their preferences better. The higher the marginal search costs, the fewer providers consumers will include in their search process. The fact that search costs exist could therefore result in consumers not including all products on offer in their search process. This discourages providers from lowering their prices, because it becomes unlikely that the price drop will be noticed by consumers.[33] As a result, the competitive pressure that providers exert on each other is reduced.

3.3.1 Effect of the standard product on the level of search costs

The introduction of the standard product does not have any effect on the level of the marginal search costs of non-standard products. However, there is an additional product variety (offered by all providers) that consumers are able to include in their search process.[34] As the product range is increased, it becomes more difficult for individual consumers to find a product with a better price-quality ratio.[35] From an individual provider's perspective, it thus becomes less likely that any price drop is noticed. As a result, providers have less strong an incentive to lower the price, thereby increasing the level of market power.

Once a consumer has gathered and analyzed information about the standard product's features of

[32] Smith et al. (1999).

[33] Stiglitz (1989), p.772.

[34] It is assumed here that the marginal search costs of the standard product are as high as the marginal search costs of non-standard products.

[35] Imagine there are ten non-standard products on the market prior to the introduction of the standard product. Also imagine that consumers gather information about just five non-standard products because of search costs. Consumers thus include 50% of all products on offer in their selection processes. After the introduction of the standard product, this drops to 45%.

one provider, it is relatively easy to include all providers of the standard product in the search process. After all, that consumer only needs to search for price information from the other providers. This means that the marginal search costs of a consumer that has already searched for a standard product are low. This helps reduce any market power on the standard product.

3.4 Switching costs as a source of market power

Switching costs are all costs that consumers must incur in order to switch providers. These include both financial switching costs as well as costs in the form of 'hassle' for consumers to switch providers or the effort that is needed to familiarize oneself with the new product. As a result, consumers are to a certain extent bound to their current provider. This is the so-called lock-in effect.[36]

Providers have a certain degree of market power over locked-in consumers. Such consumers will only switch if the price of a competitor is so low that it also offsets the switching costs. Providers can thus raise prices to just under the point where it becomes attractive for consumers to switch. The higher the switching costs are, the higher providers can set their prices, and thus the greater their market power is.[37]

3.4.1 Effect of the standard product on the level of switching costs

The introduction of the standard product is not likely to have any effect on the level of the switching costs for non-standard products. After all, it does not become easier to switch between non-standard products. In addition, there is no reason to assume that it would become easier to switch from a non-standard product to the standard product.

However, it is possible that the switching costs of leaving the standard product are lower than leaving a non-standard product. Yet, this is only the case if non-standard products have features for the sole reason of creating additional switching costs for consumers such as an unreasonably long cancellation period. The standard product could then not have such features. In practice however, it is hard to identify such product features because these switching costs have often been included because of efficiency considerations such as penalty clauses in mortgage contracts. For that reason, the switching costs and, by extension, market power are thus not likely to be restricted.

3.5 Barriers to entry as a source of market power

New entrants (or the threat thereof) can have a disciplining effect if there is insufficient competition between incumbent providers. A firm will only enter a market if it expects to have a positive business case: the expected future profits must, provided there is a reasonable return after entry, exceed the

[36] OFT (2003).

[37] It should be noted here that, since switching costs exist, the provider knows that, in the future, he will have market power over consumers that buy a product from him today. As a result, competition will initially be intense in order to secure future market power over these consumers. Therefore, the profit (of part thereof) that the provider makes on locked-in consumers down the road is already sacrificed in the first period in order to compete. This pattern is sometimes referred to as bargains-then-rip-offs (OFT, 2003).

investments (sunk costs). ACM defines a barrier to entry as anything that results in a smaller difference between the expected profits and the sunk costs.[38] The higher barriers to entry are, the less competitive pressure providers in a market experience. In that case, the market is less contestable.[39]

3.5.1 Effect of the standard product on the level of the barriers to entry

The introduction of the standard product is likely to negatively affect a potential entrant's business case. First, if the new entrant is required to offer the standard product, it leads to additional investments (sunk costs) such as training their financial advisors.[40] For the entrant, there is little profit to be gained from the standard product if the incumbent providers offer this product competitively.[41] Second, the expected profitability of the non-standard products may drop as a result of the potential shift in demand towards the standard product.[42] Third, the disciplining effect of the standard product is likely to lead to lower profits per non-standard product sold. All these elements combined could lead to higher barriers to entry.

Finally, the standard product may not fit with the entrant's commercial strategy, for example, if he wishes to bring an innovative product to market.[43] Such entry may thus be restricted because the provider is also required to offer the standard product. The same could go for innovation in general. If the standard product attracts a lot of demand, less demand is left for non-standard products. Generally speaking, this will lower the profitability of new innovations, thereby reducing the incentive to innovate.

3.6 Conclusion – standard products and market power

ACM believes it is plausible that providers will tacitly coordinate their behavior with regard to the standard product. This means they decide independently of each other to minimize the sales of the standard product in order to continue business as usual. Providers may wish to prevent competition on the standard product as it may lead to significant lower profits. This behavior from providers is easier to realize for the standard product than for non-standard products, because the behavior of competitors is easier to monitor. If it does occur, it is likely that little will change in the market in terms of competition. However, the level of market power might increase, because consumers must include an additional product in their search process. This may lead to a lower incentive for providers to reduce prices.

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[38] ACM (2014).

[39] Baumol (1982).

[40] It is suggested in the report of the Commission on the Structure of Dutch Banks (2013) that this obligation only applies to providers with a significant market share (more than 5%).

[41] In this context, it is assumed that the entrant offers the standard products as efficiently as the incumbent providers. It has already been explained in section 3.1 how the incumbent providers would respond to new entrants if they coordinated tacitly.

[42] This is not offset by the increase in total demand as a result of the reduction of stress of choice, because this additional demand is likely to fully benefit the standard product.

[43] For example if the entrant wishes to differentiate himself from competitors by offering a high level of customization.

If providers did compete on the standard product, the effect on market power would be ambiguous. After all, in this situation, too, consumers could include an additional product in their search process, which possibly gives providers more market power. Furthermore, it is also plausible that the barriers to entry will increase as a result of additional costs that providers need to make. However, competition on the standard product does, in theory, have a disciplining effect on the current product range. The actual effect on market power depends on the specific market circumstances, including the level of transparency, because it varies per case whether the increased mutual competition compensates the increased search costs.[44]

In conclusion, it seems that standard products do not automatically lead to increased competition, even if providers decide to compete on the standard product. From this point of view, it remains to be seen whether a standard product has any added value, because it does lead to additional social costs such as product development, oversight, and fixed costs for providers.

[44] For example, Stiglitz (1989, p.789) demonstrates that, under certain circumstances, entry (an additional product in the market) may lead to higher prices rather than lower.

4 Standard products and the other market failures

In chapter 2, it was explained that, in theory, the market failures information asymmetry, externalities and non-rational choice behavior could be the causes of (i) purchasing undesirable products (socially undesirable or otherwise) by consumers or (ii) underconsumption as a result of choice overload. It is discussed below to what extent standard products are able to eliminate these potential market failures. Next, it is discussed whether standard products are able to take away the presumed implications of market failures: undesirable products (socially undesirable or otherwise) and underconsumption.

4.1 Standard products and information asymmetry

Information asymmetry means that one party in the market has more information about the product in question than another party has. In this study, it is about consumers having an information disadvantage compared with providers.[45] This information disadvantage could be the result of the fact that providers withhold key information about their products from consumers. Information asymmetry could also emerge because the information is presented in a way that is not easy-to-understand or because too much irrelevant information is given. In the latter case, consumers do have all of the information, but they still may not have the necessary time, the will, and/or the cognitive skills to fully comprehend all of the conditions, and to separate the relevant parts from the less relevant parts. In effect, information asymmetry still exists in that case.

The existence of information asymmetry increases the likelihood that consumers make incorrect product choices. It is more difficult for consumers to make the right choice if they do not have or understand all of the relevant information. Not having or not understanding all of the relevant information can also lead to 'choice overload,' next to making incorrect choices.[46] With a high level of choice overload, consumers may decide to postpone their purchasing decisions, leading to underconsumption.

However, it is not plausible that consumers understand the non-standard products better with the introduction of the standard product. The information about the standard product may be provided to consumers in a manner that is easier to understand, even though this is not an explicitly stated objective, but the information asymmetry on non-standard products does not decrease as a result thereof. After all, nothing changes in the way information is provided in the case of non-standard products. The standard product is thus not likely to have any effect on the level of information asymmetry with regard to the non-standard products. It is therefore uncertain whether the standard product is able to reduce information asymmetry, and is thus able to lead to better choices and less underconsumption.

[45] The Dutch Minister of Finance talks about the problem of 'knowledge asymmetry.' See Parliamentary Papers II 2013/14, no. 15, item 4, p.16.

[46] Iyengar & Lepper (2000), and Oxera (2013), p.13.

4.2 Standard products and externalities

Externalities arise if the consumption or production of a good or service involves benefits or costs for others. This may lead to inefficient outcomes, if consumers insufficiently or fail to take into account these externalities.

The failure to include externalities in the purchasing decision may lead to undesirable product choices and underconsumption (from society's point of view). These externalities may be found in a product variety (incorrect product choice) or in whether or not to purchase a specific financial product (underconsumption). If an individual consumer purchased another product variety or if he did purchase the product instead of not, it would be beneficial for society as a whole but not for the individual consumer (see box 6).

However, the standard product, in principle, does not help reduce externalities, because the standard product does not result in consumers immediately taking into account externalities in their decision-making process. In other words, the externalities are not internalized as a result of the standard product. Moreover, ACM has not identified any existing financial product that involves significant externalities without these already having been addressed by regulation (see for example Box 6).

Box 6: Externalities in varieties and products

Externalities can be found in both a specific product feature, and thus in a product variety, or in the product as a whole.

One example of an externality in a specific product feature is the degree of amortization inmortgages. By amortizing less, consumers built less equity in their homes, thereby increasing the likelihood that they need to apply for social benefits. From society's point of view, it would be more beneficial if consumers amortize more.

One example of an externality, in the decision whether or not to purchase the product, is car insurances. That is why all car owners are required to take out car insurance. In their considerations when taking out car insurance, they probably insufficiently take into account the chances of them causing an accident, as well as the damage that is caused as a result thereof. Car insurances guarantee that the damage that is caused to others by the insured is compensated. This is a positive externality, and victims are thus protected. In this example, it is more important that individuals have car insurance. The exact variety thereof is less important. With regard to variety, consumers are better able at making a choice themselves, because that choice does not involve any externalities.

4.3 Standard products and non-rational choice behavior

In practice, consumers do not always act rationally (see chapter 2). One of the reasons is that, in reality, consumers (as opposed to the *homo economicus*) have limited time, will, and cognitive skills.

Non-rational choice behavior may lead to incorrect product choices. The use of heuristics may lead to biases in the decision-making process, which may directly lead to incorrect product choices. Time-inconsistent and context-dependent preferences may also result in consumers making undesirable choices (socially undesirable or otherwise), even if little effort is required to find the right product that meets an individual consumer's preferences. A product choice that meets incorrect (biased) preferences is still the wrong choice.

Non-rational choice behavior can also be the cause of underconsumption or of choice overload that leads to underconsumption. Consumers may feel they get too much information (an information overload), making understanding and comparing products more difficult. This can happen with both the amount of information and the way the information is presented. This information overload may result in consumers postponing their product choice.[47] Time-inconsistency, too, can lead to postponement behavior. At that point, consumers are no longer willing to search and compare, and would rather postpone this until a future time, even though these consumers know they would be better off if they did make a decision.[48]

The standard product does not seem to help directly reduce behavioral biases. After all, it does not result in more time, will, and/or cognitive skills for consumers. Neither does it make consumers more aware of the biases in their preferences or of the mistakes that consumers make in their decision-making process when using heuristics.

Interim conclusion regarding other market failures

Following from the above, information asymmetry, externalities and non-rational behavior may be causes of (i) product choices (socially undesirable or otherwise) and (ii) underconsumption (or choice overload that leads to that). However, the standard product does not seem to address these market failures directly. For example, it seems unlikely that the standard product can take away the information asymmetry on non-standard products. It also seems unlikely that externalities are internalized by the standard product. Finally, standard products do not seem to make consumers more aware of their biases in their preferences and in the decision-making process. From that perspective, it is unclear which market failure the standard product is aimed at, and it seems more logical to intervene in such a way that market failures are addressed directly.

4.4 Added value of standard products and alternative solutions

Although the standard product does not seem to address the market failures directly, it may limit the harmful effects of market failures indirectly. That is because the standard product takes advantage of the fact that consumers do not always make rational choices. As already described in chapter 2, consumers may consider the standard product as being of higher quality or use it as the starting point for their search processes. If the standard product does have this effect, consumers could act *as if* information asymmetry, externalities or non-rational choice behavior no longer existed. This may have welfare-enhancing effects. It is described below to what extent that is possible.

Consumers that, prior to the introduction of the standard product, did not buy any product as a result of choice overload may be better off if they 'blindly' go for the standard product. The standard product may not be the best product for these consumers (certain non-standard products could meet their preferences better), but it is still better than postponing their purchases. For this group of consumers, the standard product can be an effective form of government intervention.

[47] Oxera (2013), p.13.

[48] Oxera (2013), p.14.

Consumers that did buy products prior to the introduction of the standard product may be directed towards the standard product in a future purchase decision. This could work out positively for some of these consumers. It is possible that, prior to the introduction of a standard product, some consumers made their choices without searching extensively. The introduction of the standard product could direct a share of these consumers towards a product that better meets their preferences compared with a random choice. In this case, a standard product thus curbs undesirable product choices (socially undesirable or otherwise).

However, the introduction of the standard product can have negative effects for other consumers. First, there are consumers for which the choice without searching extensively was better than the standard product. In addition, there might be consumers who will search less extensively for the product that meets their preferences best. These consumers may falsely assume that the standard product meets their preferences best, and could thus be worse off in terms of product choice. The standard product could therefore lead to a welfare decrease for these consumers (as a result of the disruption of the decision-making process) instead of the presumed welfare enhancement.

This makes it clear that standard products are a crude instrument of government intervention. First, they do not directly address any existing market failures that could be the cause of undesirable product choices (socially undesirable or otherwise) and underconsumption. Second, they do not seem to merely affect consumers that would benefit from them, but they would also have an unwanted effect on consumers by directing them towards a single product variety. This also makes clear that there is a case for standard products if a more homogeneous demand is assumed than a heterogeneous demand. In that case, it is theoretically possible to improve consumer choices by directing consumers towards that one product variety that is best for all consumers. However, ACM does not consider such demand homogeneity very likely, and, in addition, the risk for government failure increases with a more homogeneous demand (see Box 7).

Alternative intervention methods

In any case, it seems more obvious to address market failures directly. If there is information asymmetry, it is more logical to impose requirements on the provision of information. Behavioral economics tell us that, with regard to information asymmetry, it is not only the amount of information that is important, but also the way in which that information is presented. Moreover, too much information (including irrelevant information) can similarly be as bad as too little information.[49] Taking into account non-rational choice behavior, methods to reduce information asymmetry can be explored. For example, a comparison tool could be set up, allowing consumers to find all relevant information in one place, making it easier to compare and choose. In addition, a study commissioned by the European Commission[50] reveals that simplification and standardization of product information may help consumers make better choices. The benefit of these alternatives is that they directly address information asymmetry, and that it does not unnecessarily disrupt the decision-making process.

[49] Oxera (2013), p.13.

[50] Chater, Huck & Inderst (2010, p.9 and 389).

If there are any externalities, it is more logical to address them directly through, for example, tax incentives. A real-world example thereof is the mortgage market, where consumers in the Netherlands only qualify for mortgage interest deduction if the entire mortgage is paid off linearly (annuity). In addition, a mandatory purchase can be contemplated when it comes to significant externalities such as with car insurances and health insurances. Again, the benefit thereof is that it directly addresses market failures without unnecessarily disrupting the decision-making process.

Finally, non-rational choice behavior may exist. There are many forms of non-rational choice behavior, which means it is more logical to find specific solutions for specific forms of non-rational choice behavior. Insofar this contributes to information asymmetry, one such solution could be to make information more understandable by imposing requirements on the way information is presented. Insofar the biases involve preferences, it is harder to correct these. Studies have revealed that, for example, educating individuals about financial products has a limited effect.[51] If there are compelling arguments as to why it is in the individual consumer's interest to buy the product, a mandatory purchase can be considered.

4.5 Conclusion – standard products and the other market failures

Information asymmetry, externalities and non-rational behavior may be causes of (i) product choices (socially undesirable or otherwise) and (ii) underconsumption (or choice overload that leads to that). The standard product does not seem to address these market failures directly. However, the standard product may limit the negative effects of market failures indirectly. This is possible if it limits choice overload, and thus underconsumption, for a share of consumers, or if it has consumers make better product choices if the standard product is the product that meets their preferences best.

However, this positive effect is likely to come with negative side-effects. It could disrupt the decision-making process of consumers who currently already purchase products that meet their preferences. These consumers would thus actually be worse off as a result of the standard product. For this reason, it seems more effective to deal with any existing market failures directly and at the core. This may be simplification and standardization of product information, thereby reducing information asymmetry. Tax incentives, too, may internalize externalities more effectively, thereby reducing underconsumption.

[51] Oxera (2013), p.17.

Box 7. Are standard products able to improve product choices?

In a situation of demand heterogeneity and a heterogeneous product range, standard products could, in theory, improve consumer choices. In that case, it means that the government is able to develop a product variety that is best for all consumers. This is theoretically possible, but in the real world, there is a great risk of government failure.

First, standard products are only able to correct existing market failures in very specific situations. In reality, demand must be very homogeneous (otherwise it is suboptimal that consumers are directed towards a single variety), whereas consumers behave as if demand is heterogeneous because of one or multiple market failures. This situation is not entirely inconceivable. Scitovsky already wrote in 1950 that product complexity can be a source of market power.[52] By deliberately making products more complex, it becomes harder for consumers to understand and compare products, as a result of which the price elasticity of demand decreases. Despite this possibility, products are generally speaking complex to be able to offer a heterogeneous selection for a heterogeneous demand.[53] Product complexity in itself is therefore not a reason for concern. It will thus be difficult to determine at what point the product range is complex to meet the heterogeneous demand of consumers, and at what point it is unnecessary complexity in order to confuse consumers.

Second, it remains to be seen whether there are any markets where demand is truly homogeneous. According to ACM, demand in every market is heterogeneous to some degree (see also chapter 2). Since the standard product directs consumers towards one product variety, it will never be able to correct existing market failures completely. This means that some sort of mismatch between product preferences and product choices will always exist.

Third, it presents a challenge to the government to determine what specific product variety meets consumer preferences best. If consumers themselves do not really know what their preferences are, then how can the government be able to discover what consumers' true preferences are? If this were at all feasible, it would take a lot of knowledge and expertise to do so. This is particularly true for non-rational choice behavior. What should be taken into consideration at all times is the possibility that the assumed behavioral biases are not even biases at all, and that consumers indeed act rationally according to their preferences.[54] It would be equally unwise to assume in advance that certain behavioral biases exist in the market. After all, the scientific literature reveals that such biases are strongly context-dependent. Minor contextual changes could lead to biases having completely different effects or even to their absence. The existence of non-rational choice behavior should thus be examined empirically on a market-by-market basis.[55]

In conclusion, there is a real risk that the standard product will be introduced in a market that is actually not suited for it. Even if a suitable market can be found, there is a risk that the wrong product variety is chosen as the standard product. In both scenarios, the standard product would direct consumers towards the 'wrong' product variety. In that case, the standard product would actually contribute to making the incorrect product choices, thereby reducing social welfare.

5 Conclusions and recommendation

5.1 Conclusions

In part at the request of the ministry, ACM assessed to what extent the possible introduction of standard products is able to reduce or solve three presumed problems, which are: insufficient competition, undesirable product choices (socially undesirable or otherwise), and underconsumption as a result of choice overload. These problems may be the result of the presence of market failures, despite the fact that these market failures have yet to be demonstrated empirically. Since market failures can be a reason for government intervention, ACM examined to what degree the introduction of standard products help reduce various forms of market failures. This ACM study focused on the market failure of 'market power', or a possible lack of competition.

Based on theoretical analysis, there seems to be no reason to assume that standard products will enhance competition. There is a genuine risk of providers, independently from each other, deciding to minimize the sales of the standard product. As a result, they are able to continue business as usual. The level of competition is thus likely to remain unchanged or may, at worst, even decrease. This is because consumers need to compare an additional product in their search process, making them less sensitive to price reductions. Even if providers do compete on the standard product, no unequivocally positive effect on the level of competition in the entire market is expected. By expanding the product range, and fiercer competition on the standard product, the mutually disciplining effect may increase, but in this case, too, consumers will have to compare more products. The final effect depends on the specific market circumstances, and which of the previous two effects will dominate.

With regard to the other forms of market failures (information asymmetry, externalities and non-rational choice behavior), standard products do not seem to directly help reduce these. They might reduce the effects of these market failures such as underconsumption or undesirable product choices (socially undesirable or otherwise), but that does come at the expense of the consumers' decision-making process (disruption). Consumers could then possibly solely focus on the standard product, making them not necessarily better off, given the heterogeneous preferences. That is why measures that are directly aimed at solving market failures seem more logical. Examples include simplification and standardization of product information or the introduction of tax incentives.

This ACM study was carried out without there being any clarity about the exact design of the

[52] Scitovsky (1950). The FCA (2013, p.23), too, points out the possibility of "spurious differentiation" in order to abuse behavioral biases.

[53] Kalayci & Potters (2011).

[54] FCA (2013, p.33)

[55] One way to possibly do this is look for indicators that may point to non-rational choice behavior. The FCA (2013) distinguishes provider behavior, product features, and consumer behavior.

standard product, and about the exact nature of the problems that the standard product needs to solve. In that sense, the abovementioned conclusions are of a provisional nature. Based on this study, ACM comes to the conclusion that standard products carry little opportunities and big risks for competition.

5.2 Recommendation

The theoretical analysis carried out by ACM reveals that the introduction of standard products do not (or not enough) deal with the presumed problems and underlying market failures. Should the ministry wish to further develop the concept of standard products, ACM recommends that the ministry carry out further empirical research. Such research should, for example, make clear to what degree the identified problems exist in practice, and what their direct causes are. Limited competition can, for example, also be caused by capacity restrictions of providers.[56] The introduction of standard products does not take these away. This immediately leads to the necessity of additional research in order to determine how the identified causes of the problems can be solved in the most efficient and effective manner. As already mentioned, ACM also sees other solutions to the presumed problems, which may be more effective, and intervene in the market to a lesser extent. This will lead to more effective government interventions, which is ultimately in the interest of consumers.

[56] ACM (2013).

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