Financial Illiteracy Meets Conflicted Advice

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This presentation

- I am going to discuss the results of a series of papers I have written concerning the topic of financial illiteracy meets conflicted advice as it relates to pension participants.

Financial Literacy and Financial Advice

- Because many people lack financial literacy they seek financial advice.
- Information asymmetry is inherent in this situation, with the adviser having superior information and knowledge compared to the client.
- This asymmetry creates a potential for an agency problem, where the agent may not act in the best interest of the client.

Conflicts of Interest

- People seeking advice in the U.S. are likely to encounter an adviser who has a conflict of interest.
- Because of the way the adviser is compensated, the advice that yields the adviser the most income is not the best advice for the client.

Regulation

- Because of the problems in the market for advice, government has instituted regulations in an attempt to protect clients.
- Three approaches have been taken in law to deal with conflicts of interest: prohibition, disclosure, and the fiduciary standard.
- In addition, financial education is a policy response.

Fiduciary Standard

- The fiduciary standard requires that the advice be in the best interest of the clients.
- In principle, a fiduciary standard, if it were enforced, would solve the agency problem.

Fiduciary Standard continued

- The fiduciary standard is generally considered the gold standard in regulation of conflicts of interest. It holds the agent to the highest possible standard concerning acting in the interests of the client.
- However, to my knowledge the effect of having a fiduciary standard has never been empirically tested.

Fiduciary Standards

- While the fiduciary standard requires that advisers act in the best interests of their clients, different organizations impose different fiduciary standards, differing in whether conflicts of interest are permitted or prohibited.

Problems with Fiduciary Standards

- Fiduciary standards have a number of problems.
- First, because of the amount of money involved, the financial services industry attempts to weaken the standards and weaken their enforcement.
- Second, because clients are financially illiterate, they often do not know when they are receiving bad advice.

Problems (continued)

- Third, because of their financial incentives, financial advisers, even those with a fiduciary standard, are motivated to provide advice that is not in the best interest of their clients when conflicted advice is permitted.
- Fourth, some common ways that advice is transmitted are not regulated in the United States.

Perfect Storm

- Bad outcomes in terms of financial advice generally require the “perfect storm” of 3 events.
- 1) financially illiterate clients
- 2) financial advisers with a conflict of interest
- 3) weak regulations or weak enforcement

Regulatory Capture

- Because of the large amounts of money at stake in fees, financial advisers through their membership organizations attempt to influence the regulator, which when successful is called regulatory capture.
- During the 2013-2014 election cycle, the financial services industry spent $1.4 billion.
- They also attempt to influence the regulatory process through seeking favorable decisions in the courts.

Regulatory Capture of the SEC

- The fiduciary standard of the Securities and Exchange Commission (SEC) is weak.
- The adviser can advise to do something in the adviser’s interest so long as he discloses his fees.

Advice Not Covered by Standard

- Advice from one adviser to one client is covered.
- Generalized advice, such as through websites and other sources of marketing, even though it can be generally bad advice, is not covered.

Pension Rollovers

- I have applied this framework for analyzing advice to the issue in the U.S. of pension rollovers to Individual Retirement Accounts (IRAs).
- IRAs are now the largest source of retirement funds, having overtaken 401(k) plans and DB plans.
- However, few people contribute to IRAs.
- The growth in IRAs is almost entirely due to rollovers.

Key Importance

- Thus, rollovers to IRAs are a key issue in the structure of the US retirement income system.
- Behavioral economics predicts that due to inertia, few people would roll over to an IRA.
- Inertia has been overcome by bad financial advice from advisers with a conflict of interest.

Sources of Advice

- Advice to roll over comes from 3 sources:
- 1) financial advisers to clients,
- 2) pension record keepers to participants who have changed jobs
- 3) generalized advice
- Generalized advice is not regulated, there has been no regulation of advice from record keepers, and advice from financial advisers is weakly regulated.

Rollovers and Advice

- Because of the importance of the rollover decision, many people seek financial advice.
- One study (ICI 2015) finds that 61 percent of people with a rollover IRA received financial advice from an adviser in connection with the rollover.

Why roll over?

- The industry standard reason given by financial advisers with a fiduciary duty for rolling over from a 401(k) plan to an IRA has to do with diversification.
- “401(k)s have only a small number of investment options. IRAs have virtually unlimited investment options.”
- The advice thus relates to diversification.

Diversification

- Diversification is a complicated concept.
- Financially unsophisticated investors often use the simple heuristic (rule of thumb) that more investment options is better.
- The financial services industry takes advantage of this lack of sophistication in its marketing.

Fees

- The financial services industry also takes advantage of the lack of knowledge of pension participants concerning the level of fees they are paying and their lack of knowledge concerning the importance of fees on investment outcomes.

Diversification in 401(k) plans

- 401(k) plans are required by law to provide participants enough options to be adequately diversified.
- The average number of options provided is 25.
- I have done a study of one plan with 5 investment options (the Thrift Savings Plan), showing that with only diversified 5 options, it is possible to be well diversified.

Bad advice—Bad analysis

- The bad advice to roll over to more costly IRAs is thus based on bad analysis—the heuristic that more options is better.
- It is also based on people not knowing about the importance of fees.
- In addition, advisers do not appear to consider fees when providing advice.

The Dark Side of Behavioral Economics

- The dark side of behavioral economics is that financial advisers take advantage of the lack of knowledge and the behavioral biases of their clients.
- Advisers tell a half-truth—more investment options outside of 401(k) plans.
- This misleading statement fails to disclose that more options are not necessary to be adequately diversified and they will lead to higher fees.

Thrift Savings Plan

- As an example of what I am talking about, consider the Thrift Savings Plan.
- The Thrift Savings Plan is the 401(k)-type plan for federal government workers, the military and Members of Congress.
- It charges extremely low fees—less than 3 basis points for each of its investment options.
- Despite its low fees, financial advisers advise participants to roll over to IRAs.

TSP Rollovers

- The industry average fee for target date funds is more than 30 times higher than the target date funds in the TSP.
- Yet, 18 percent of civilian members of TSP who are separated from TSP say they plan to rollover because of lower fees.
- Thus, financial illiteracy plays a role in participants being susceptible to bad advice.

Fiduciary Standard

- In research with two coauthors, we conducted a small email survey of 15 advisers who had a fiduciary standard for their advice and compared the results to a similar survey of advisers without a fiduciary standard of conduct.
- Both sets of advisers were asked to advise about rolling over from the Thrift Savings Plan.

Results

- We found a statistically significant difference between the two surveys, but from an economic perspective the results were weak.
- A number of advisers with a fiduciary standard still recommended a roll over from the TSP, despite its low fees of less than 3 basis points.
- It appears that advisers frequently do not weigh the presumed benefits of their advice against its cost.

Conclusions

- We argue that the market for financial advice is characterized by financially illiterate consumers meeting conflicted advice.
- Traditional economics and behavioral economics are unable to explain pension rollovers, while our version of an agency model is able to explain the rollovers.
- Many consumers are insensitive to large differences in financial market fees.

Conclusions 2

- While inertia, as well as traditional economics, would indicate that TSP participants would not roll over to mutual funds with fees 20 or 30 times as high, we argue that inertia has been overcome by bad advice from financial advisers, as well as by the generalized advertising campaign encouraging pension rollovers.

Conclusions 3

- We document that having a fiduciary standard does affect the quality of advice, but the effect is weaker than we anticipated.
- Having a conflict of interest still appears to affect the quality of advice.
- It appears that frequently advisers with a fiduciary standard in our survey did not weigh the benefits of their advice against its costs.

Conclusions 4

- In the United Kingdom, this type of advice is called “pension mis-selling,” and is considered to be a scandal.