

Fiduciary Duty and the Market for Financial Advice

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Fiduciary standards designed to alleviate potential conflicts of interest

- ▶ Not all advisers are fiduciaries → current policy debate
- ▶ State common law, (failed) DOL Rule, SEC Best Interest, state statute

How would fiduciary duty affect the market for financial advice?

- ▶ Proponents: Better net returns through higher costs of distorted advice
- ▶ Detractors: Increase fixed costs, no effects on advice

How does fiduciary duty impact product sales and market structure?

- ▶ Shift towards higher-return products (\sim \$10K for average contract)
- ▶ Lower downside risk, more choices, higher quality investment options
- ▶ Small market contraction

How would laxer or stricter regulation affect entry and advice?

- ▶ Effects could be due to costs of distorted advice \uparrow or fixed costs \uparrow
- ▶ Develop a model to show how to disentangle channels
- ▶ Advice channel is dominant \implies increasing stringency continues to improve advice

Roadmap

1. Institutions and Data
2. Reduced-Form Effects of Fiduciary Duty
3. Understanding the Mechanisms
4. Effects of Increased Stringency

All annuity sales for 2013–15 from a major financial services provider (FSP)

- ▶ Detailed information on FSP customers, advisers, and products sold

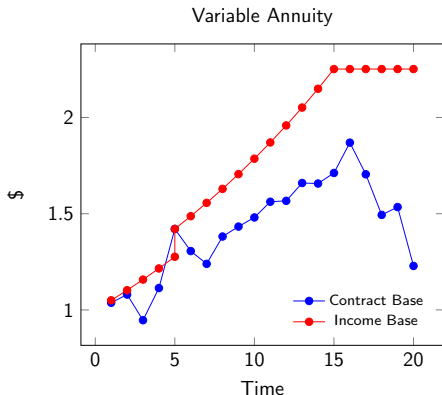
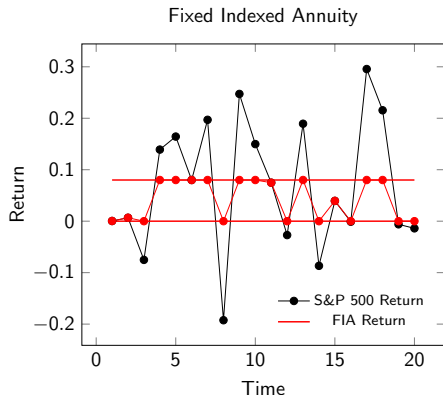
Information about products

- ▶ Contract terms for all products and riders collected from prospectuses
- ▶ Fund rating, investment styles, fees, historical returns

Snapshot of the financial advisor market in 2015

- ▶ All advisers who can sell annuities

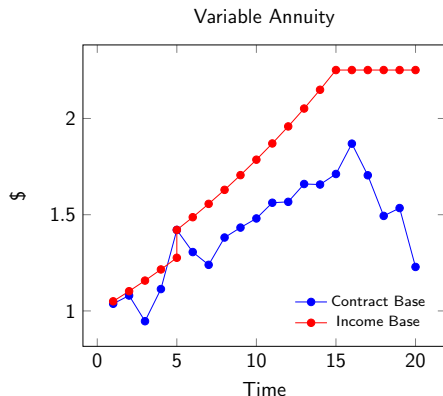
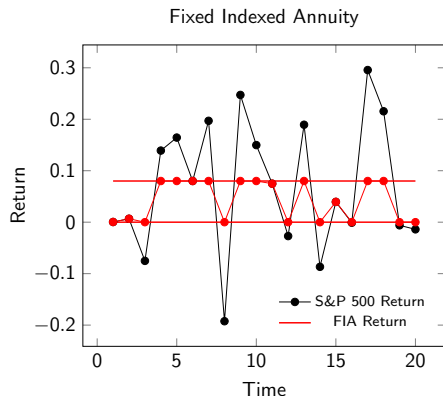
The Structure of Deferred Annuities



Fixed Indexed Annuity

- Choose a crediting strategy → value of the account can never fall

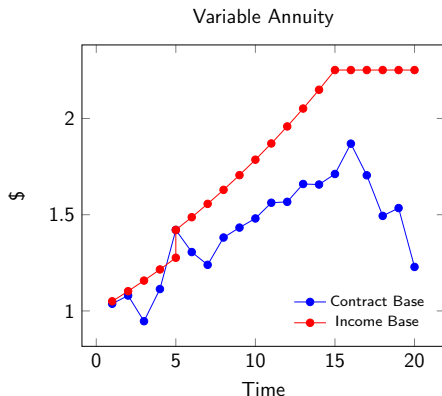
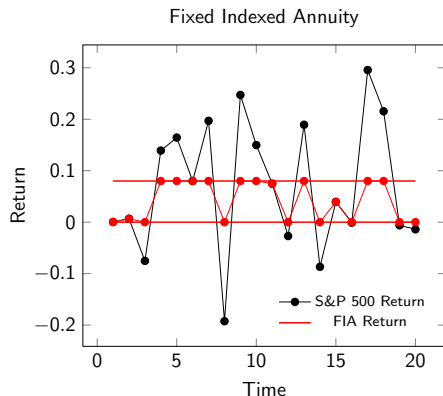
The Structure of Deferred Annuities



Variable Annuity

- ▶ Allocate investments across funds, subject to restrictions
- ▶ Insurance value increasing with returns and age at first payout

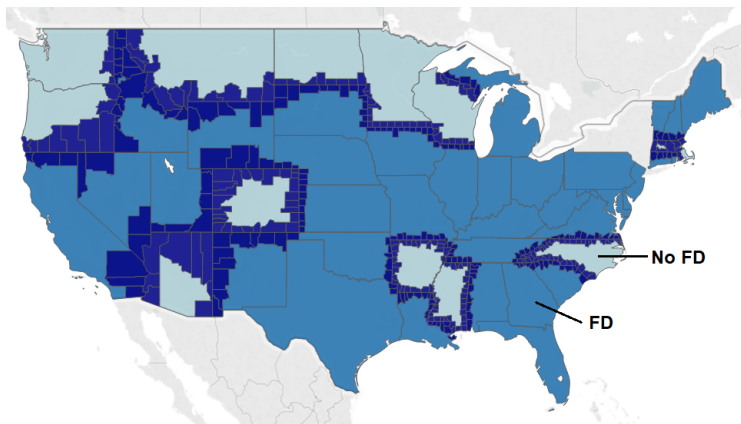
The Structure of Deferred Annuities



VAs → more complex, larger battery of fees, riskier

- ▶ But neither product is dominated
- ▶ Structure of fees and characteristics lets us construct net valuation

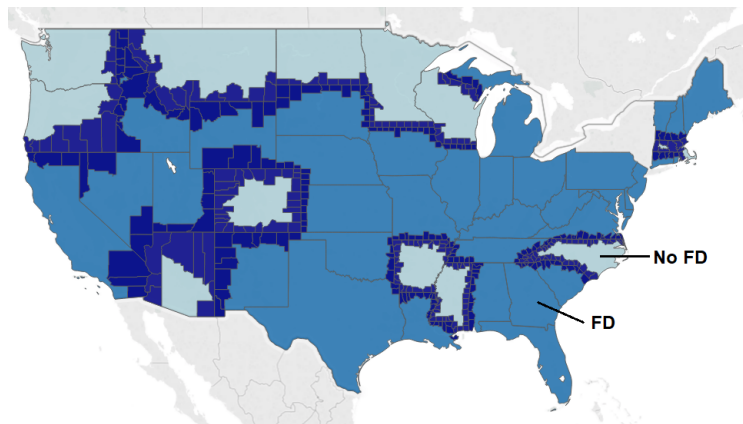
Common Law Fiduciary Duty in the US



Two types of financial advisers

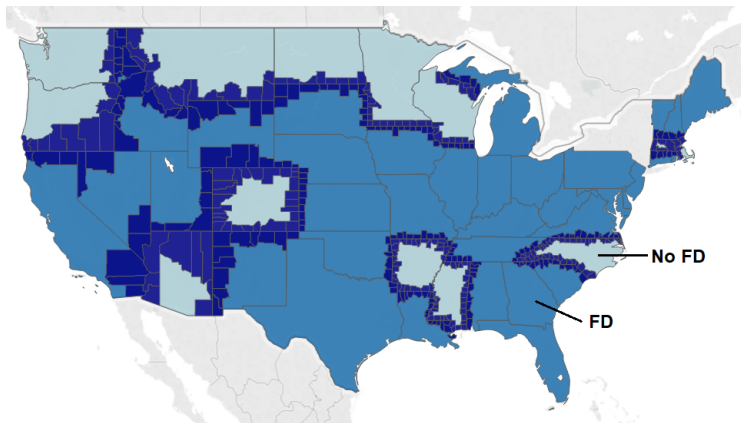
- ▶ Control: RIAs have fiduciary duty at the federal level
- ▶ Treatment: BDs subject to common law fiduciary duty in some states

Common Law Fiduciary Duty in the US



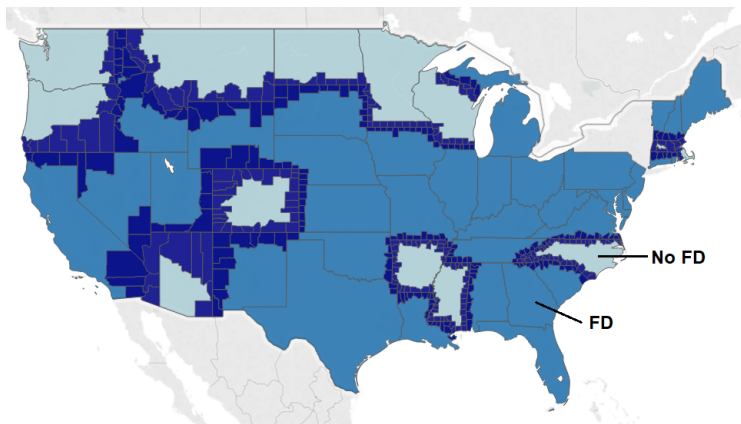
$$Y_{ist} = \alpha_0 + \alpha_1 \cdot \mathbb{1}[\text{State has FD for BDs}]_s \cdot \mathbb{1}[\text{Advisor is a BD}]_i \\ + \alpha_2 \cdot \mathbb{1}[\text{State has FD for BDs}]_s \cdot \mathbb{1}[\text{Advisor is an RIA}]_i \\ + \alpha_3 \cdot \mathbb{1}[\text{Advisor is a BD}]_i + \text{Border FE} + \text{Age FE} + \text{Month FE} + \epsilon_{ist}$$

Common Law Fiduciary Duty in the US



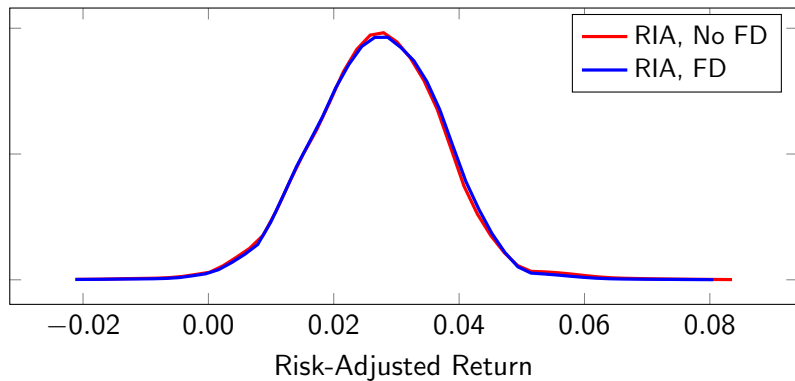
- 22,472 transactions, \$140K on average, average age of 64

Common Law Fiduciary Duty in the US

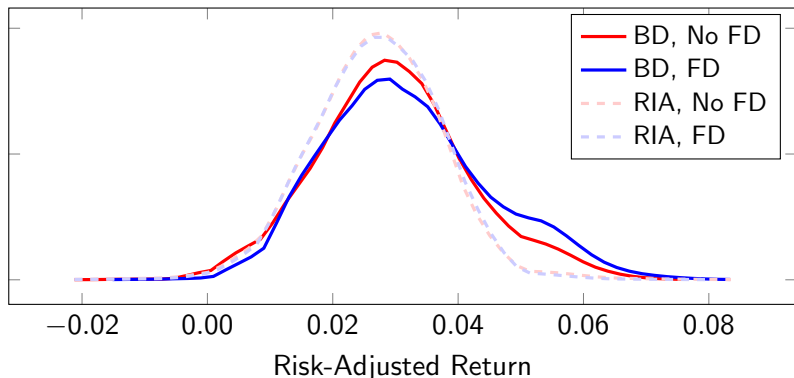


- ▶ Demographic covariates and client characteristics are balanced
- ▶ Survey evidence that clients are unaware of fiduciary status
- ▶ Limited effects on RIAs in almost all dimensions

Effects on Returns



Effects on Returns



- ▶ Risk-adjusted return \uparrow by 25 bp (s.e. 11 bp) off a baseline of 2.8%
- ▶ Unadjusted return \uparrow by 47 bp (s.e. 23 bp) off a baseline of 6.4%

Effects on Characteristics

Shift towards products with lower downside risk

- ▶ Probability of VA \downarrow by 13%
- ▶ 10th percentile of return distribution \uparrow by 27%

Increase in the diversity of choices

- ▶ Number of investment options \uparrow by 8.7%
- ▶ 11.9% \uparrow for funds rated ≥ 4 stars
- ▶ More coverage of equity and fixed income styles by highly-rated funds

Mixed results on fees

- ▶ Average expense ratio increases, but lower minimum expense ratio
- ▶ Increase in fund returns, net of expense ratios
- ▶ No significant change in M&E fee and surrender charge

$$Y_c = \beta_0 + \beta_1 \cdot \mathbb{1}[\text{FD}]_c + \text{Border FE} + \text{County Covariates} + \epsilon_c$$

- ▶ Number of BD firms ↓ by 16%
- ▶ No statistically significant change in the number of RIA firms, overall VA sales, and number of FSP contracts sold

Potential Channels

Fixed
costs ↑

**Fiduciary
Duty**

Cost of
distorted
advice ↑

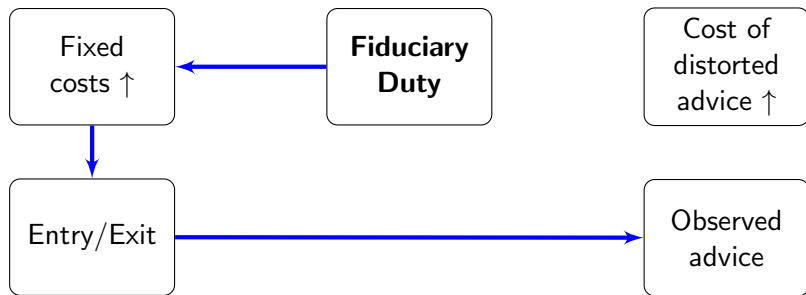
Entry/Exit

Observed
advice

- ▶ Observed changes can be rationalized by either channel
- ▶ Quantifying channels key for implications of increased stringency

Potential Channels

Fixed Cost Channel

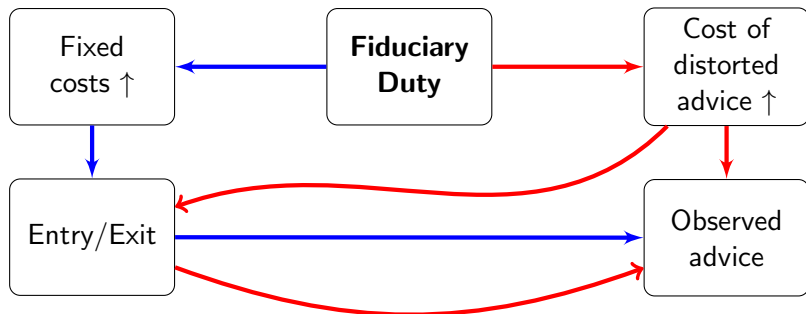


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Potential Channels

Fixed Cost Channel

Advice Channel



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Ingredients of the Model

- (i) Heterogeneity across firms in latent quality of advice
- (ii) Possibility of entry and exit

▶ A firm of type θ earns base profits $\pi(a; \theta)$ from advice a

$$a^*(\theta; FD) \equiv \arg \max_a \pi(a; \theta) - \mathbb{1}[FD] \cdot c(a)$$

$\pi^*(\theta; FD) \equiv$ the associated maximum profit

- ▶ Higher a corresponds to “worse” advice
- ▶ Distribution $H(\cdot)$ for firm types θ
- ▶ If mass μ firms enter, then each firm earns $f(\mu) \cdot \pi^*(\theta; FD) - K(FD)$

Equilibrium: All firms who make positive profits enter

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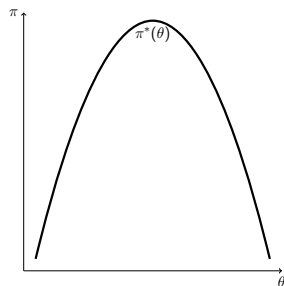
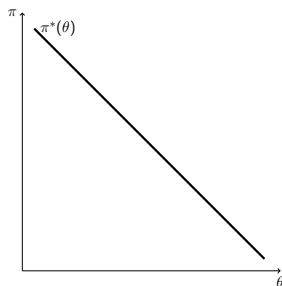
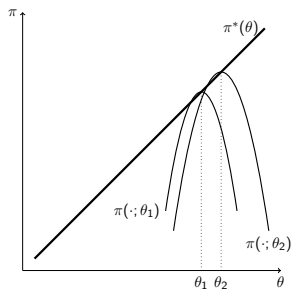
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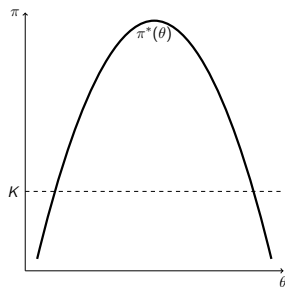
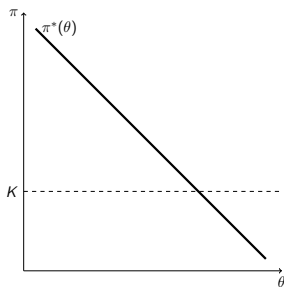
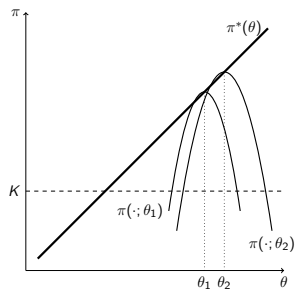
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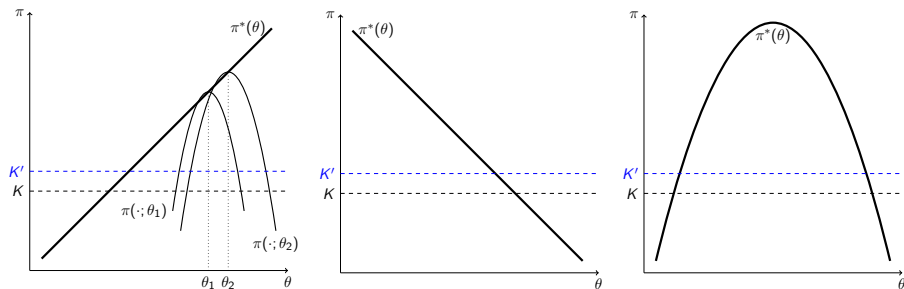
The Fixed Cost Channel



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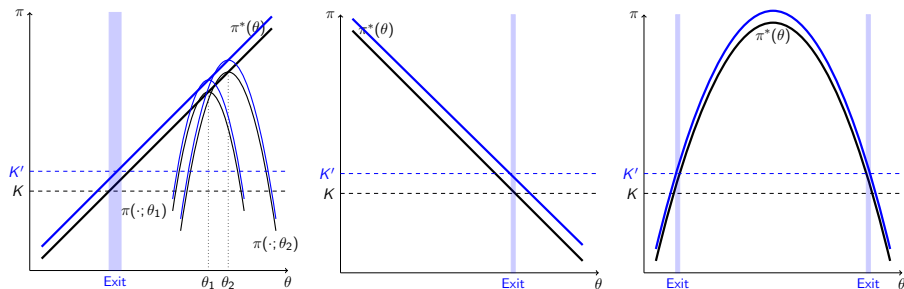


The Fixed Cost Channel



- Suppose fiduciary duty operates entirely through an increase in K

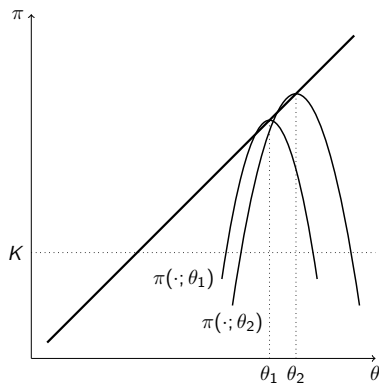
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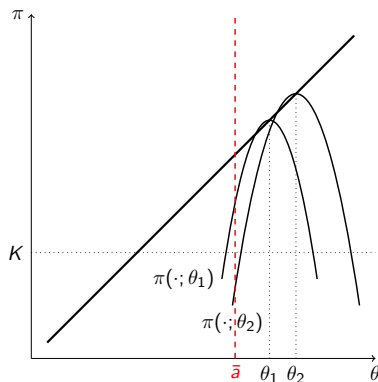
- ▶ Suppose fiduciary duty operates entirely through an increase in K
- ▶ Some firms no longer profitable \rightarrow exit (\rightarrow effective profit increases)

In all situations, extremes of advice (weakly) contract.

The Advice Channel

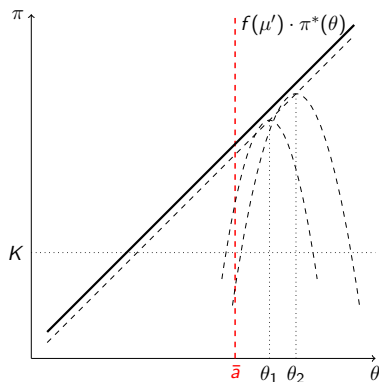


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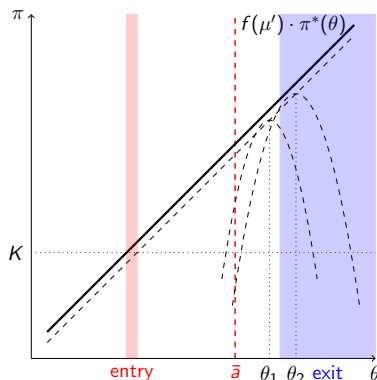
- ▶ Example: Fiduciary duty is implemented by a cap in distortion
→ some firms cannot profitably change advice and must exit

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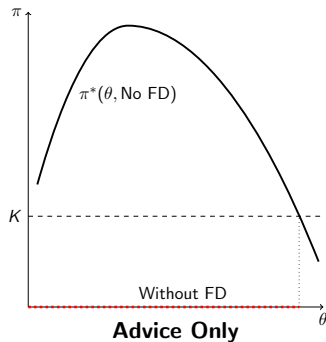
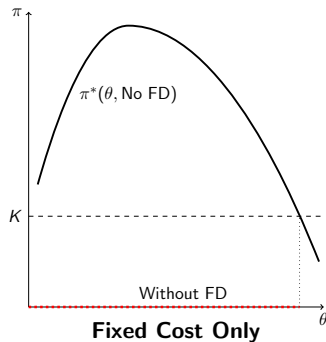
Possible improvement in best advice ← entry + within-firm changes

Distinguishing the Channels

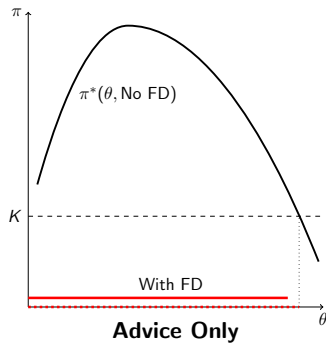
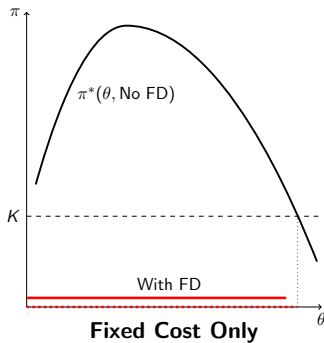
1. Highest risk-adjusted returns in market improves with FD
2. Within-firm changes in products transacted

Both observations imply an empirically relevant advice channel

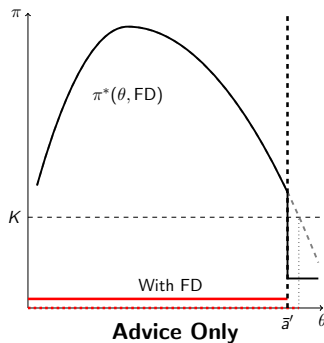
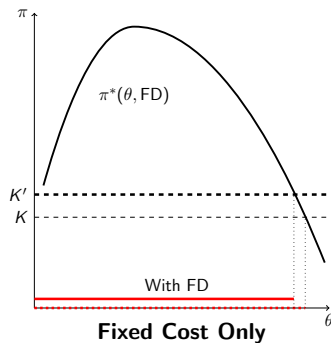
Why should we tell channels these apart?



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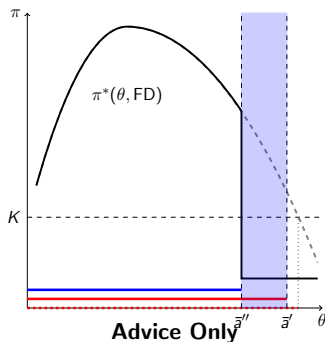
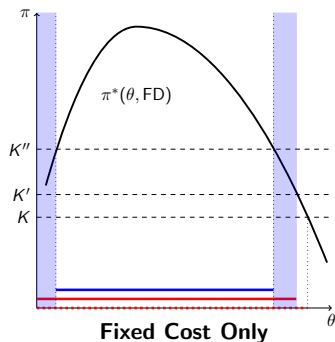


Why should we tell channels these apart?



- Improvements in advice can be rationalized by either channel

Why should we tell channels these apart?



- ▶ Improvements in advice can be rationalized by either channel
- ▶ Strong advice channel \rightarrow more likely strengthening fiduciary standards further improves investor returns

Parameterization of the Structural Model

$$\pi_{mf}^T(\theta_f) \equiv \max_a f^T(N_{BD}, N_{RIA}) \cdot \pi_m^T(a; \theta_f) - K_{mf}^T, \text{ for } T \in \{BD, RIA\}$$

- ▶ Uncertainty over potential competitors' types θ_f and fixed costs K_{mf}
- ▶ Enter if $\mathbb{E} [\pi_{fm}^T(\theta_f)] \geq 0$, given equilibrium beliefs over other entrants

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$$\pi_m^{RIA}(a; \theta_f) \equiv g^{RIA}(\theta_f) - \lambda_{RIA} \cdot (\theta_f - a)^2$$

$$\pi_m^{BD}(a; \theta_f) \equiv g^{BD}(\theta_f) - \lambda_{BD} \cdot (\theta_f - a)^2 - c \cdot a^2 \cdot \mathbb{1}[FD]_m$$

- ▶ $g^T(\cdot)$ allows profits to relate to optimal distortion flexibly
- ▶ (λ_{BD}, c) parameterize the advice channel

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$$f^T(N_{BD}, N_{RIA}) \equiv \frac{1}{(N_T + 1)^\gamma + \alpha \cdot (N_{-T} + 1)^\gamma}$$

- ▶ γ parameterizes the market expansion effect
- ▶ α parameterizes the degree of cross-type competition

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$$K_{mf}^T = \kappa_0 \cdot \mathbb{1}[FD]_m + \kappa_1 \cdot \mathbb{1}[BD]_f + \kappa_2 \cdot \mathbb{1}[FD]_m \cdot \mathbb{1}[BD]_f \\ + \text{Border FE} + \text{County Controls} + \epsilon_{mf}$$

$$\epsilon_{mf} \sim N(0, 1)$$

- ▶ κ_2 parameterizes the fixed cost channel
- ▶ Mirrors reduced-form DID

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$$\begin{aligned} H^T(\theta) &\sim N(\mu_\theta^T, \sigma_\theta) \\ a &\sim N(a^*(\theta_f; FD), \sigma_a) \end{aligned}$$

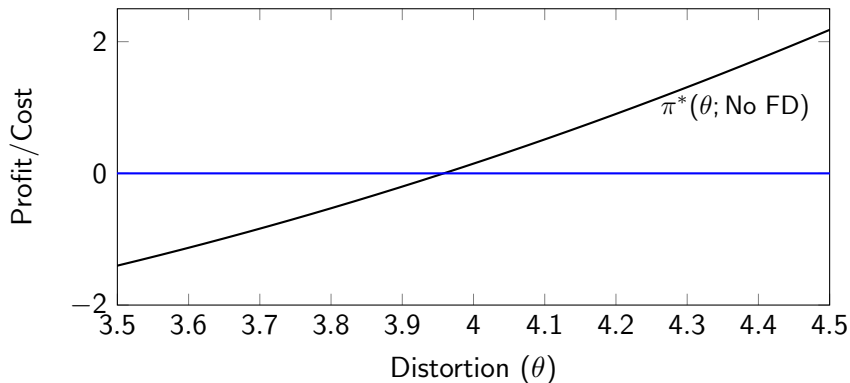
- ▶ Advice $a \rightarrow$ risk-adjusted return (partial out border, age, month FEs)
- ▶ θ_f fixed within firm across markets

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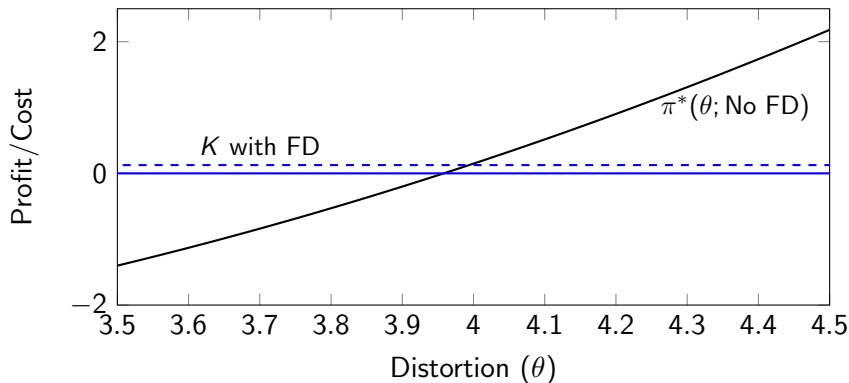
Match distribution of advice and entry using a computational Bayes approach

Summary of Parameter Estimates



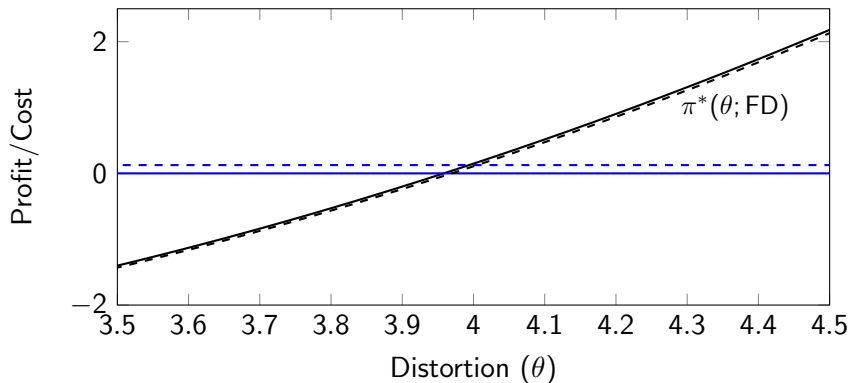
- Profitability increases with distortion

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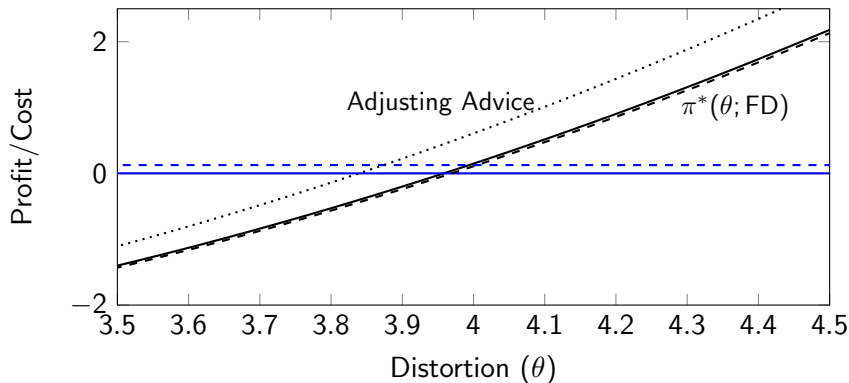
- ▶ Profitability increases with distortion
- ▶ Increase in fixed costs due to fiduciary duty

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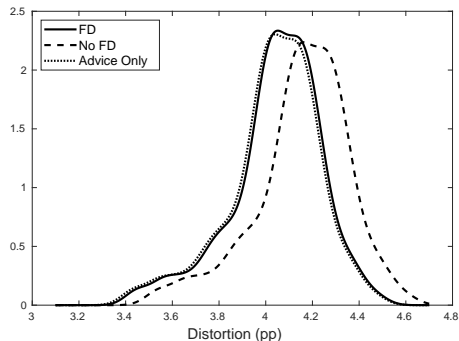
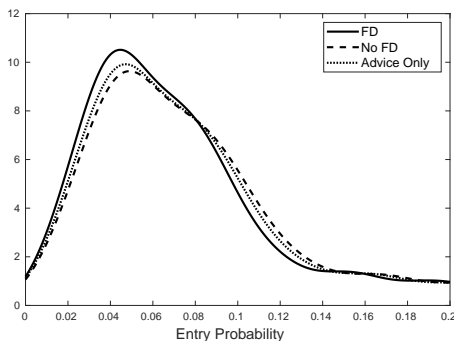
- ▶ Profitability increases with distortion
- ▶ Increase in fixed costs due to fiduciary duty
- ▶ Strong advice channel

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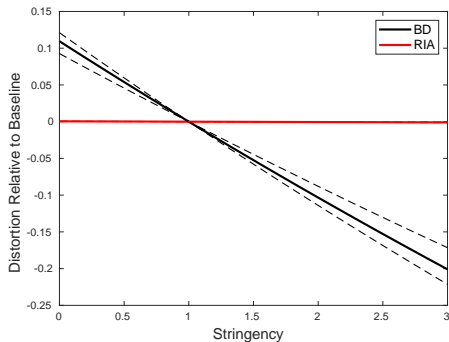
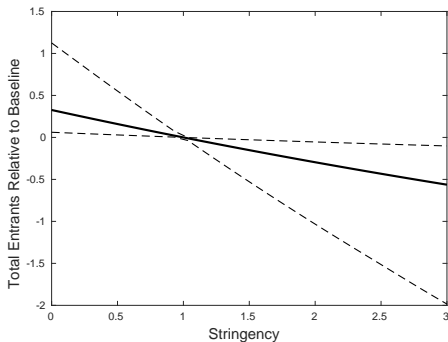
- ▶ Profitability increases with distortion
- ▶ Increase in fixed costs due to fiduciary duty
- ▶ Strong advice channel

Quantifying the Channels



- ▶ Both advice and fixed cost channels contribute to exit
- ▶ Advice channel is the dominant force in reducing distortion

Changing Stringency of Fiduciary Duty



- ▶ Despite modest exit of broker-dealers, advice continues to improve with stringency

Conclusion

- ▶ Common law fiduciary duty leads to increase investor returns and moderate exit of advisers
- ▶ Develop and estimate a model to conclude that effects are consistent with increased cost of distortion → not just an increase in fixed costs
- ▶ Increased stringency continues to improve investor returns