

Fiduciary Duty and the Market for Financial Advice

Vivek Bhattacharya, Gastón Illanes, and Manisha Padi

Northwestern University, NBER, and Berkeley Law School

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Household Finance
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Motivation

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

Outline

Data and Institutions

Reduced Form Results

Understanding the Mechanisms

Effects of Changing Stringency

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

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

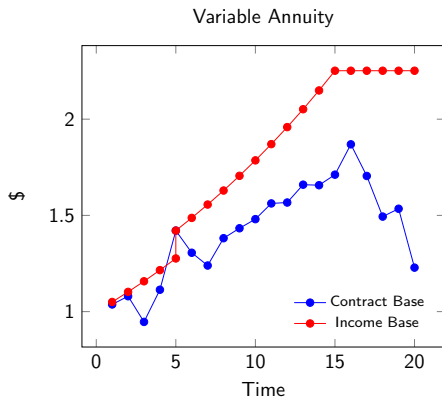
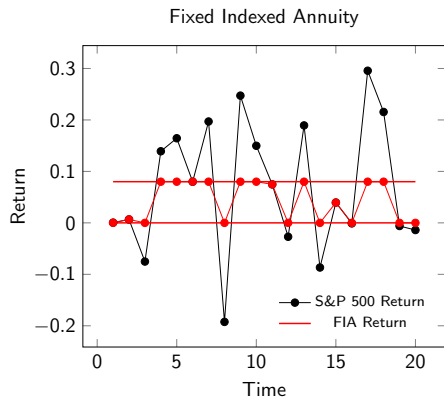
Snapshot of the financial advisor market in 2015

- ▶ All advisers who can sell annuities

Information about products

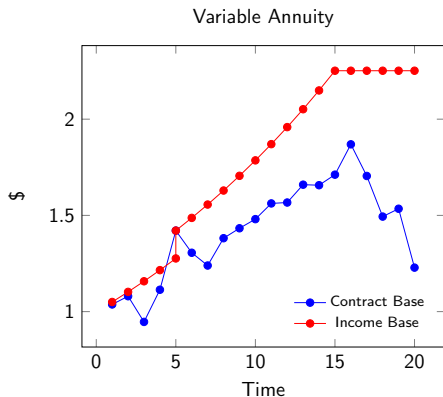
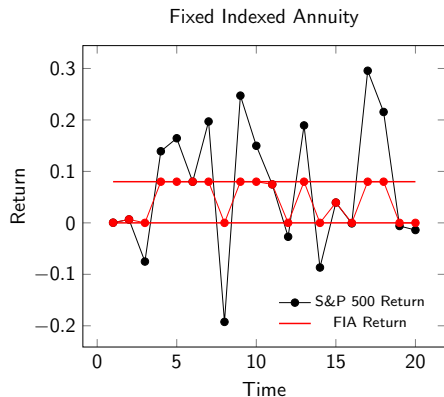
- ▶ Contract terms for all products and riders collected from prospectuses
- ▶ Fund rating, investment styles, fees, historical returns

The Structure of Deferred Annuities



- ▶ **Fixed Indexed Annuity:** Choose a crediting strategy → value of the account can never fall
- ▶ **Variable Annuity:** allocate investments across funds → insurance value increasing with returns and age at first payout

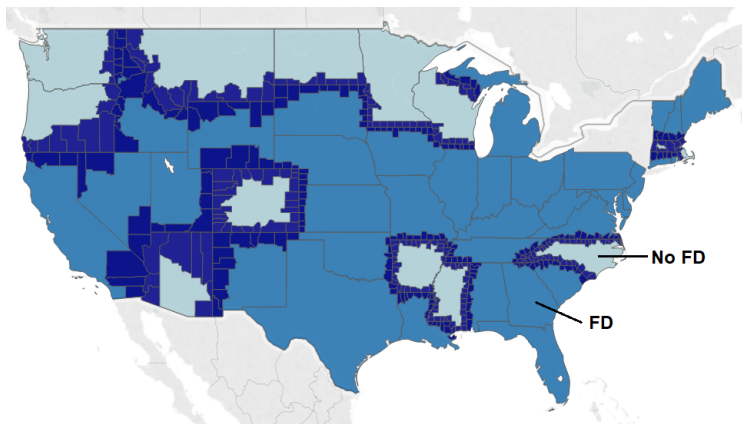
The Structure of Deferred Annuities



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

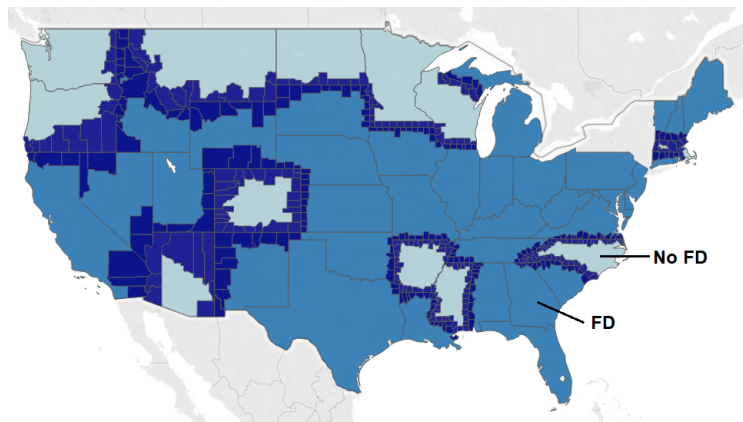


Two types of financial advisers

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

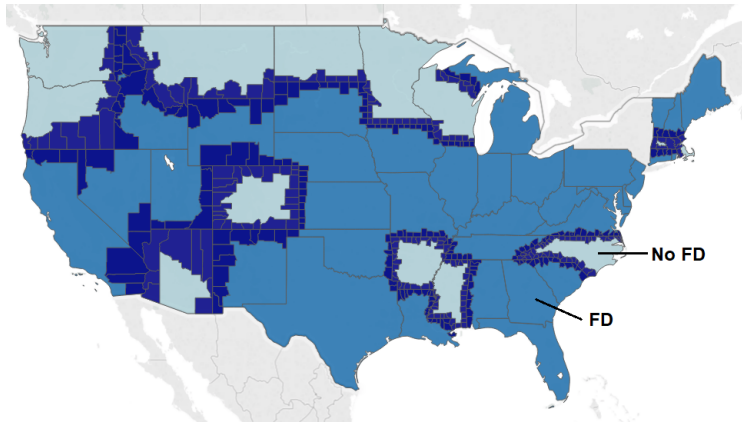
Border sample: 22,472 transactions, \$140K on average, average age of 64

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



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

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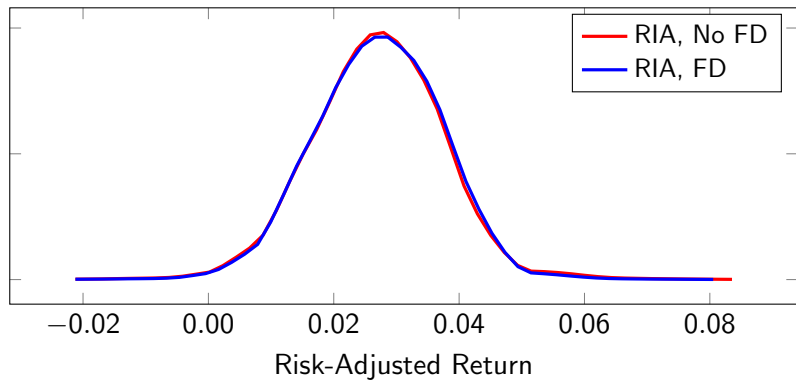
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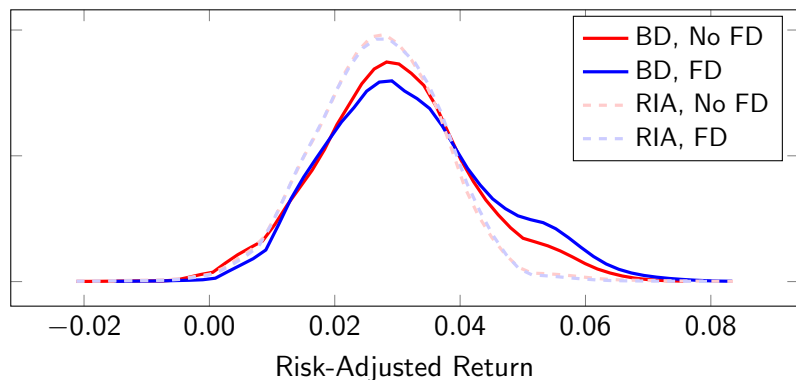
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Effects of Changing Stringency

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 ↓ by 13%
- ▶ 10th percentile of return distribution ↑ by 27%

Increase in the diversity of choices

- ▶ Number of investment options ↑ by 8.7%
- ▶ 11.9% ↑ 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

Market Structure

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

- ▶ 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

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Potential Channels

Fixed
costs ↑

**Fiduciary
Duty**

Cost of
distorted
advice ↑

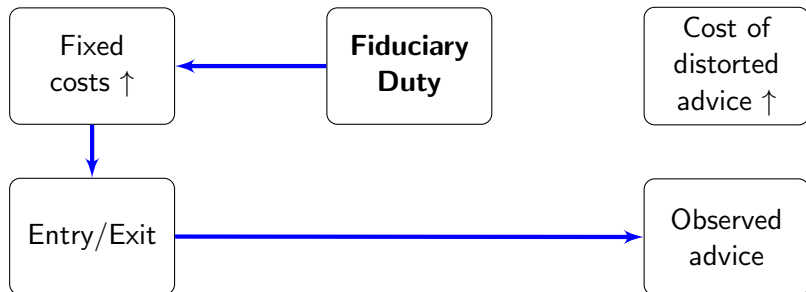
Entry/Exit

Observed
advice

- ▶ Observed effects can be rationalized by fixed cost or advice channels
- ▶ Disentangling channels key for predicting effect of counterfactual stringency

Potential Channels

Fixed Cost Channel

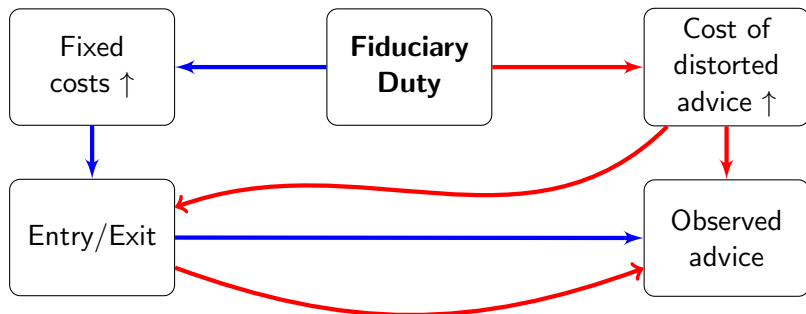


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Potential Channels

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_j earns base profits $\pi(a; \theta_j)$ 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 $f(\mu) \cdot \pi^*(\theta; FD) - K(FD)$
→ in equilibrium, all firms who make positive profits enter

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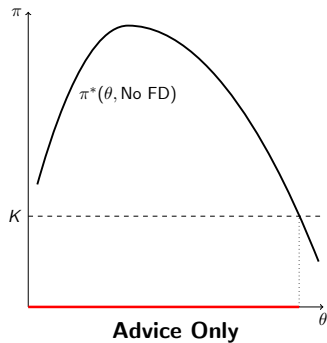
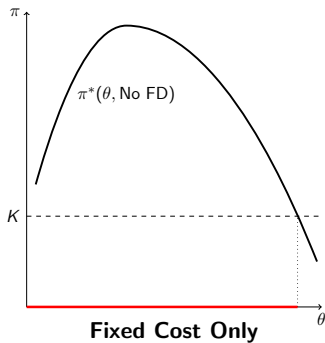
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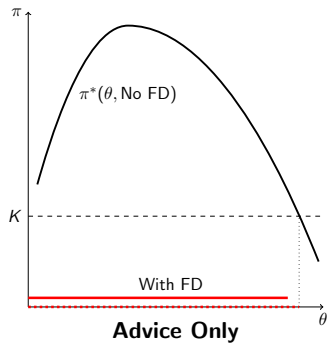
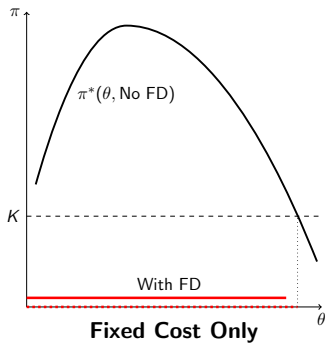
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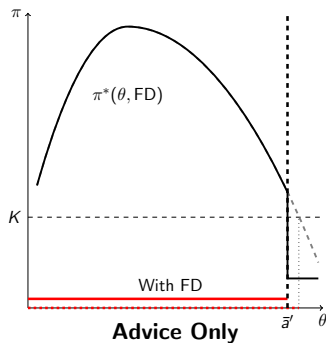
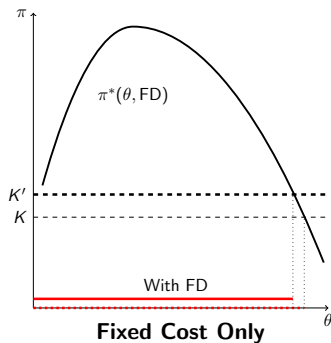
Disentangling Channels



Disentangling Channels

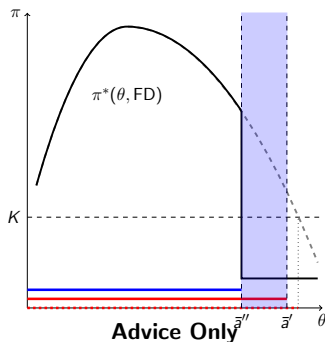
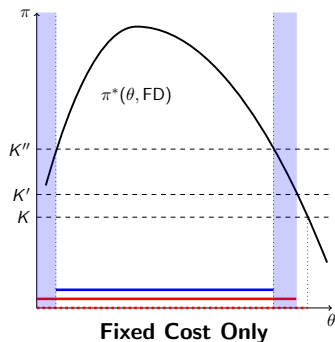


Disentangling Channels



- ▶ Improvements in advice can be rationalized by either channel

Disentangling Channels



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

Distinguishing the Channels

Implications of pure fixed cost channel:

1. Extremes of advice (weakly) contract
 - ▶ Highest risk-adjusted returns in market improve with FD
2. No within-firm effects
 - ▶ Suggestive evidence of within-firm improvements in returns

Both observations suggest advice channel is empirically relevant

Distinguishing the Channels

Quantify forces using structural model closely tied to the reduced-form

- ▶ Compare differences in **distribution** of risk adjusted returns
 - ▶ Proxy for advice
- ▶ Fit fully flexible function mapping distorted advice to profitability
 - ▶ Estimate $\pi^*(\theta)$
- ▶ Allow for endogenous entry, comparing across borders
 - ▶ Latent type θ is constant within firm
- ▶ Use RIAs as a control
 - ▶ FD does not directly affect their costs

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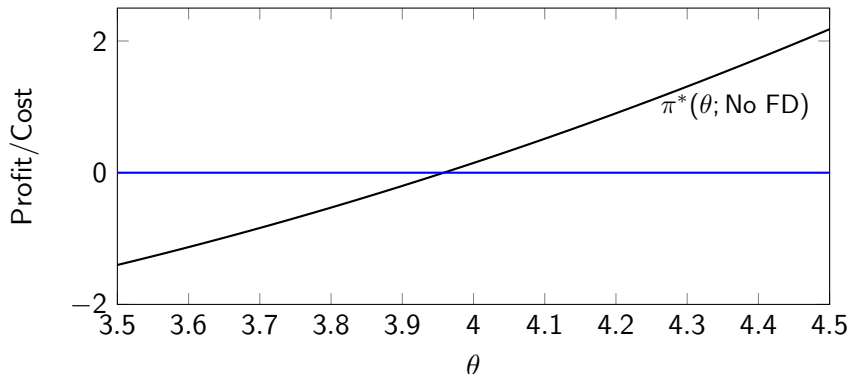
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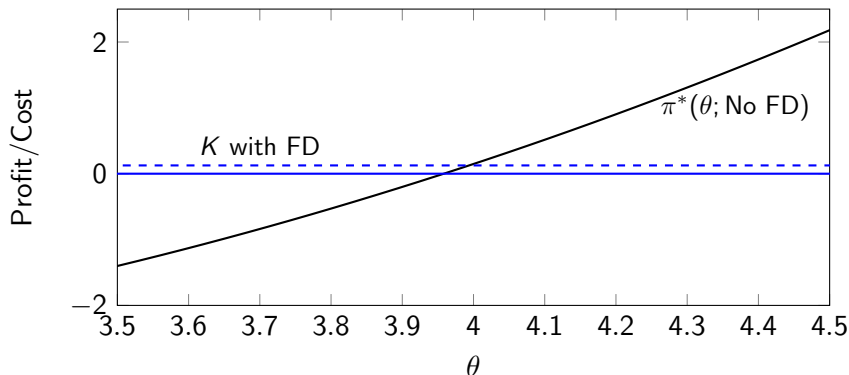
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Summary of Parameter Estimates



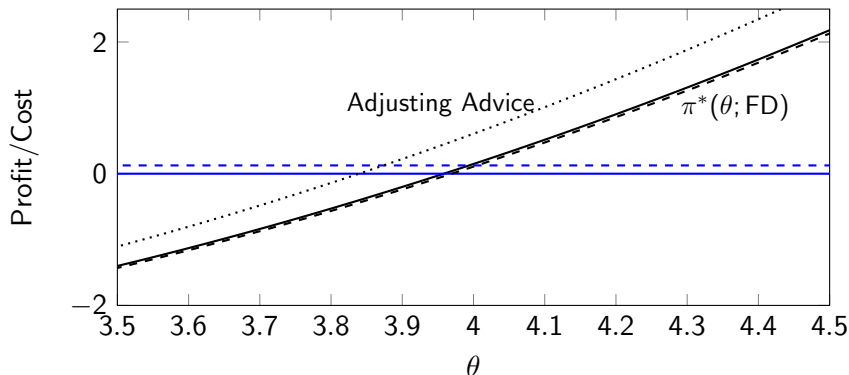
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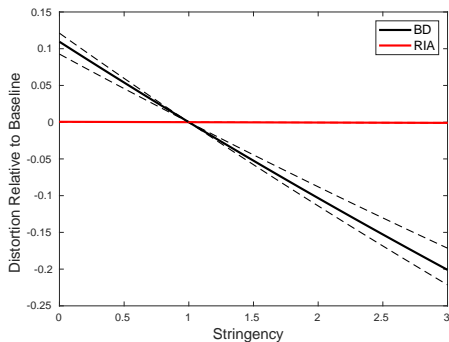
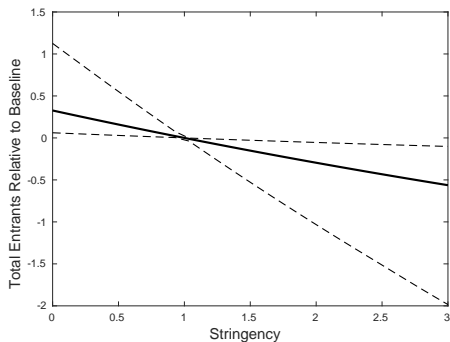
- ▶ Profitability increases with distortion
- ▶ Increase in fixed costs due to fiduciary duty

Summary of Parameter Estimates



- ▶ Profitability increases with distortion
- ▶ Increase in fixed costs due to fiduciary duty
- ▶ Advice channel has net effect of decreasing distortion

Changing Stringency of Fiduciary Duty



- ▶ Tripling stringency results in modest exit of 0.5 firms per market
- ▶ Despite this, BDs would improve advice by a further 20 bp

Conclusion

- ▶ **Fiduciary duty improves investor returns**
- ▶ Effects could be due to *fixed cost channel* or *advice channel*
- ▶ Quantifying through structural model → advice channel is dominant
- ▶ More stringent FD monotonically improves returns, despite some exit

- ▶ Ongoing policy debate about SEC's Reg BI and state legislation → future effects remain to be seen