Fiduciary Standards for Broker-Dealers Would Help, Not Hurt Savers

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MarketWatch Blog by Alicia H. Munnell

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Industry Reaction Are Slightly Hysterical.

The Department of Labor (DOL) is expected to re-propose regulations that will create fiduciary responsibilities for financial services providers. The form that the proposed regulations will take is not yet known.

In 2010, the DOL proposed eliminating third-party incentive payments (such as 12b-1 fees) that encourage broker-dealers and others to sell high-fee mutual funds to holders of Individual Retirement Accounts (IRAs). The 2010 proposals did not change the standard of conduct; broker-dealers and others could continue to operate under a "suitability" standard rather than the "in the sole interest of" standard required of fiduciaries under the Employee Retirement Income Security Act of 1974.

This time around, the DOL may try to change the standard of conduct, as well as restrict the access to incentive payments to sell high-fee products. This seems like a modest goal. One would hope that providers were already behaving in this fashion!! But this has not stopped the financial services industry from launching an attack.

A recent study, undertaken by Quantria Strategies LLC, and commissioned by a coalition of financial services providers, concludes that the modest DOL proposals would be extremely costly. (Remember, no one knows what the DOL is going to propose.)

The study analyzes the effect that imposing a fiduciary standard would have on the 401(k) participants who are considering what to do with their 401(k) money when they change jobs. The study claims that the imposition of the fiduciary standard may eliminate access to call-centers and broker-dealer assistance with respect to distribution advice. In the absence of advice to roll their money over to an IRA, millions of workers, particularly low-wage and minority workers, will cash out their retirement plans. Cash–outs on job change will increase by \$20-\$32 billion a year, and the ultimate retirement savings of affected individuals would decrease by 20-40 percent.

The above calculations rest on a flawed assumption and a flawed econometric model. The flawed assumption is that, faced with the imposition of a fiduciary standard, all financial institutions will stop answering the phone. A much more reasonable assumption is that companies will respond to competitive pressures and will continue to search for business, while complying with whatever regulation the DOL imposes.

The econometric model involves estimating the effect of the receipt of financial advice on plan balances. It is estimated using data from the American Life panel, a nationally representative dataset. The dependent variable is the logarithm of the sum of 401(k), IRA, and Keogh plan balances. The explanatory variable of interest is a dummy variable taking the value one if the participant uses a financial planner or broker, zero otherwise. The other explanatory variables include income, age, financial literacy, health, job tenure, and share of portfolio I stocks. The coefficient on the “planner” variable is 0.33, meaning that participants who have a financial planner have roughly a third more wealth than those who don't, controlling for other factors.

The problem with the model is that we cannot say that the financial planner "caused" the participant to have more wealth, and hence the loss of access to the financial planner would cause a reduction in wealth. An equally, and perhaps more, plausible explanation is that the causation runs in the other direction – individuals who are thrifty, wealthy, or financially sophisticated to start with find it more worthwhile to hire a financial planner. If they lost their financial planner, they might invest a little less successfully but they would still be thrifty and financially sophisticated. In the context of 401(k) distributions, it is more plausible to believe that those who are more disposed to roll over their plan balances seek out advice on where to invest than to believe that call centers and financial advisors play a significant role in turning spenders into savers.

The costs of raising standards of conduct in the financial services industry are illusory. But the benefits are real – in terms of lower fees, more appropriate asset and portfolio allocations, and a better alignment of advice with the interests of the individual investor.