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Can Regulations Improve Financial Information and Advice?

Tennyson, Sharon†

A B S T R A C T

Many governments are considering strengthening regulations for financial advisors. New regulations have been enacted in a number of countries, including the United Kingdom, Australia, the Netherlands, Singapore, and United States. Many other countries, including Canada and the European Union as a whole, are actively considering new regulations. Interest in these policies reflects both the disappointing progress on improving consumers' financial literacy, and the recognition of significant conflicts of interest in these markets. This article discusses rationales for regulatory reform and considers various approaches to reform.

Keywords: financial advisors, consumer protection, financial advice regulation

I. Background

Due to the increasing sophistication of retail financial markets, and in response to trends including rising household debt burdens, aging populations and public pension reforms, governments around the world have focused on promoting consumer financial literacy (OECD, 2016). In 2003 the OECD established a major program on financial literacy and financial education, to promote international efforts to raise consumer financial literacy (Padoan, 2008). Research, practice and policy aimed at enhancing consumer knowledge and behaviors in financial markets proliferated. By 2008 an International Federation on Financial Education (INFE) had been established, with membership representing 80 countries and over 200 government bodies (INFE, 2009). *The Economist* magazine likened the public policy focus on consumer financial education to a "global crusade" (April 3, 2008).

The 2008 global financial crisis assured continuing attention to the issue, as many observers cited consumers' lack of financial literacy as a contributing cause (INFE, 2009). At least 14 G-20 nations and 21 European nations adopted "national strategies" to promote financial literacy (Griffony and Messy, 2012). A number of national central banks (e.g., Brazil, France, Latvia) have introduced money museums with interactive educational displays designed to improve financial literacy (OECD, 2016). The Programme for International Student Assessment (PISA) added a financial literacy assessment component in 2012, to provide educators and policymakers insights into the financial knowledge and skills of high school students (see discussion in Lusardi, 2015).

With this came a notable shift in emphasis toward promoting financially responsible behaviors. In 2008 the OECD Deputy Secretary characterized his organization's efforts in financial education as motivated by the belief that "financial literacy and awareness clearly promotes economic growth and wellbeing, by expanding the quality of available financial services, and by enhancing the ability of individuals to more effectively use these services for their best interest" (Padoan, 2008). However, a 2016

† Cornell University
Editor for Journal of Consumer Affairs
sharon.tennyson@cornell.edu

OECD report on financial education in Europe noted "As can be expected, most national strategies for financial education in Europe share the same goal of strengthening financial literacy, fostering responsible financial behavior, and increasing financial resilience of individuals by improving their financial literacy." (OECD, 2016, p. 31). As a result of the crisis, financial literacy is now seen as important not only for economic growth and individual empowerment, but for stability of the financial system.

The crisis also rekindled interest in the need for financial consumer protections. In 2011 the OECD published a set of six high-level principles for consumer financial protection (OECD, 2011). The 2016 OECD report on financial education strategies in Europe included a substantial section on consumer financial protection policies, and characterized the report as providing an overview of innovative policies "at the intersection of financial education, financial consumer protection and financial inclusion"(OECD, 2016, pg.7). The World Bank's International Finance Corporation (IFC) established a "responsible finance" initiative in 2010, and characterized responsible finance as resting on three pillars: consumer financial literacy, industry self-regulation, and robust consumer protections (responsiblefinance.worldbank.org); and governments around the world have augmented consumer financial protections in recent years.[1]

II. Markets for Financial Advice

Financial advisors and sales agents are an important source of information for consumers, but are also in a position to exploit consumers' lack of information. A recent review of academic literature in this area concludes that there is substantial evidence of bias and conflicts of interest in markets for financial advice (Burke et al., 2015). The history of financial advice scandals provides additional evidence of bias in perhaps more practical and measurable terms (e.g. Steen et al., 2016).

Whether advisors and agents provide useful information has also been called into question. The behavioral finance literature documents that stock analysts and advisors suffer from many of the same biases common to consumers and investors, including overconfidence and herding behavior (e.g. Menkhoff et al., 2013). Analyst stock recommendations do not fare well in tests against market returns (Baker and Dumont, 2015; Hackethal et al., 2011). Bluethgen at al. (2008) find a high degree of quality variation in investment advice provided by independent financial advisors in Germany, and Anagol et al. (2015) find evidence that poor advice from insurance agents in India may reflect limited product knowledge among the agents themselves.

Of course, the received value of advice must be measured in relation to the decisions that an individual investor would take without it. Bhattacharya et al. (2012) and Hung and Yoon (2010) find that those who seek financial advice tend to benefit, but many who could potentially benefit do not act on professional advice that is unsolicited. Gaudecker (2015) finds little significant effect of financial advice on investment choices of most households, but one exception is that low-numerate households who do not utilize financial advice make significantly poorer choices.

Some studies find that comprehensive financial advice – as distinct from advice about specific investment choices – may add value due to portfolio diversification effects, savings effects, and financial management effects (Bluegthen et al., 2008; Montmarquette and Vienne-Briot, 2015). Winchester and Huston (2015) find significant benefits along a spectrum of financial preparedness (greater retirement savings, better use of employee benefits, and larger emergency funds) for middle income households who receive comprehensive financial advice, but no benefits from focused investment advice. Consistent with this result, Montmarquette and Vienne-Briot (2015) find no immediate benefits to households from using a financial advisor, but that households who receive professional advice for at least four years have greater net worth. Gains are associated with higher savings rates and a greater allocation of wealth to non-cash assets.

Unfortunately, the social significance of advisors may be limited by selection into the use of advisor. Most studies find that individuals with high financial capability are more likely than less financially capable individuals to seek advice (Cacagno, 2012; Collins, 2012; Robb et al., 2012). Studies also find that financial advice is more

[1] For example, the United Kingdom and the United States have both established new financial consumer protection regulators (Financial Conduct Authority and Consumer Financial Protection Bureau, respectively).

likely to be sought by highly educated and wealthier individuals (Hackethal et al., 2012; Marsden et al., 2011). Bachmann and Hens (2015) expand on these findings by showing that behavioral and emotional capabilities in investing (e.g. the ability to avoid common psychological biases) are positively associated with financial advice-seeking.

Low financially literate individuals may be less likely to seek financial advice because they lack ability to judge the quality of the advice that they receive. Moreover, they may believe that the quality of advice they receive will be poor. Theoretical research shows that financial advisors may have greater incentive to offer high quality advice to more financially literate clients (Inderst and Ottaviani, 2012; Bucher-Koenan and Koenan, 2015). Empirical work by Bucher-Koenan and Koenan (2015) and others shows that advice quality does indeed vary across clients based on external signals of financial sophistication including education and gender (Oehler and Kohlert, 2009; Anagol et al., 2013).

These findings highlight significant deficiencies in participation and outcomes in markets for financial advice. Results which show that markets for information and advice do not serve the interests of the most vulnerable consumers and investors make it particularly important to find policy solutions to current problems. A commitment to meaningful and consistent regulation and enforcement is needed to assure that financial advisors and agents play a positive role in supporting consumer decision-making.

III. Regulatory Design Considerations

The shared perspective of most observers is that consumer education will not solve information failures in the financial advice system,[2] and that regulations must accept and account for consumers' limitations. How exactly to do so is the more complicated problem. A primary tension in regulatory policy is to design regulations that provide sufficient protections but do not greatly reduce market efficiency or create other unintended and unwanted consequences. This tension arises because regulatory prohibitions on seller behaviors or limits on product offerings, are often discovered to have unintended negative consequences.

An alternative to direct prohibitions is to focus regulations on improving information, for example through mandated disclosures. Mandating disclosure does not restrict seller behaviors or limit the set of available products. Requiring sellers to reveal information that may otherwise be difficult to obtain provides consumers the opportunity to improve their choice behavior Shaffer, (1999). However, the practical effectiveness of mandated disclosures is often limited, since consumers may have difficulty understanding disclosures due to information complexity or decision biases (Trebilcock, 2003). The specific format, wording and amount of information disclosed has been shown to have a significant effect on whether consumers understand and use the information (Verplanken & Weenig, 1993; Wansink, 2003 ; Gathergood, 2012). As a result, recent regulatory practice emphasizes the importance of considering the research evidence on consumer decision processes when designing disclosures (Bertrand and Morse, 2011 ; Garrison et al., 2012).

The trend toward developing "libertarian-paternalistic" policies (Camerer et al., 2003) or "nudges" (Thaler and Sunstein, 2008) is an example of this approach. Such policies are intended to aid consumers who are in need of protection while not reducing choice or affecting outcomes for more sophisticated consumers. Successful policies in the consumer finance realm include automatic enrollment of employees in firms' pension plans (Madrian and Shea, 2000), and the "Save More Tomorrow" plan which increases employees' pension contributions by allowing them to precommit to increase their contributions after their next pay raise (Thaler and Benzarti, 2004).

Market and experimental evidence shows, however, that design success for "nudge" policies is no more assured than for traditional policies. For example, various nudge-based programs aimed toward increasing savings among low-income families have generally produced disappointing results (e.g., Bronchetti et al., 2013; Despard et al., 2016; Loibl et al., 2016). Credit card billing disclosures that were redesigned specifically to increase con-

[2] An alternative view is that in order to be successful financial education must start at a young age. The OECD and INFE both call for mandatory financial education in schools. The U.S. Financial Literacy Education (FLEC) 2011 strategic plan has articulated the theme of "Starting Early for Financial Success" and recently sponsored an academic symposium to address this theme (see the special issue of *The Journal of Consumer Affairs*, Spring 2015).

sumers' monthly payments by providing suggested payment amounts have little effect on the target consumer population (Jones et al., 2015) and may cause some consumers to reduce rather than increase monthly payments (Navarro-Martinez et al., 2011; Salisbury, 2014). These outcomes demonstrate that nudges may not always be sufficient, and may be particularly ineffective in solving complex policy problems (Selinger and Whyte, 2012).

Other research raises the specter of nudges being ineffective due to the ability of firms to neutralize or distort them. Willis (2004) contends that the law requiring banks to require consumer opt-in to automatic overdraft protection (rather than overdraft protection being the default) was ineffective in changing consumer behavior because banks – who profit from overdraft fees – were able to frame the choice using language that confused or frightened consumers. Willis maintains more generally that nudges will not be a successful policy tool when "(1) motivated firms oppose them, (2) these firms have access to the consumer, (3) consumers find the decision environment confusing, and (4) consumer preferences are uncertain" (Willis, 2004, p. 1155). Applying similar reasoning, Barr et al. (2008) argue that regulations need to be "behaviorally informed", taking into account not only decision biases of consumers but also firms' incentives in maintaining or changing those biases.

IV. Recent Approaches to Advisor Regulation

The above considerations are important in designing regulatory policies toward financial advisors, and examples of recent policies adopted in these markets illustrate the potential difficulties faced in regulation. With regard to direct prohibitions, recent regulations to prohibit commission-based sales (shifting to fee-based compensation from clients) for financial services agents and advisors have raised concerns about unintended consequences. There appear to be several potential unwanted effects of the commission ban. First, survey evidence suggests that consumers prefer commission-based relationships with financial advisors and sales agents (Burke et al., 2015), which might lead consumers to forego advice-seeking under fee-based systems. Moreover, theoretical work suggests that removing commission payments for agents and advisors may give financial services firms incentives to bypass the advisor/agent channel and market directly to unsophisticated consumers. Empirically, Ring (2016) argues that the UK ban on commission payments has led to a significant "advice gap" caused by both of these effects: not only are some consumers opting out, but financial advisors are targeting only high-wealth customers for advice, and banks are exiting the mass market (p.9).

Other policies suggest that nudges may be ineffective in markets for advice, due to the complex choice environment and the trust relationship established between advisors and consumers. For example, many jurisdictions have begun requiring advisors to inform clients if they are compensated by commissions from the product provider. This is intended to debias consumers' from excessive trust in the advice given by the advisor. Experimental evidence shows, however, that many consumers are willing to follow the (bad) advice of a biased agent even in the presence of a conflict-of-interest disclosure (Carmel et al., 2015). Other experiments suggest that conflict-of-interest disclosures may permit advisors to internally justify providing biased advice, leading to a greater propensity for bias (Cain et al., 2011).

Licensing requirements may also provide insufficient incentives for high quality advice. Licensing imposes minimum entry and continuing education standards, professional and ethical standards, and provides a vehicle for monitoring and enforcement of behavioral standards. Theoretically, licensing standards may raise service quality through sorting effects or through incentive effects (or both). The sorting benefits are premised on the adverse selection model of unobservable quality first proposed by Akerlof (1970) and elaborated in the licensing context by Leland (1979). In this view licensing can be viewed as a screening device for quality, which enables consumers to distinguish high-quality from low-quality goods or services. Potential incentive benefits of licensing were first elaborated by Shapiro (1986), in a model which assumes that licensing raises required human capital investments of service providers. In turn, providers will have greater incentives to provide high quality services in order to protect the rents from those investments.[3]

[3] This result relies on the additional assumptions that licensing restricts entry of competitors and that a reputation effect of service quality

In practice, empirical studies of licensing often find little or no positive effects of licensing on the quality of professional service provision (Kleiner, 2000), and many argue that licensing serves only to protect professionals from competition. Nonetheless, results vary across studies (Kleiner and Kudrle, 2000) and some recent studies find that licensing improves service quality (e.g. Law and Kim, 2005; Rigby et al., 2007). Others show more nuanced effects of licensing, including lower received quality after accounting for lower rates of professional use due to restricted supply (Carroll and Gaston 1981), and licensing standards that do not correctly target low-quality practitioners for exclusion (Goldhaber 2007).

Lex et al. (2015) study the effects of introducing agent licensing in German insurance markets, in a study which appears to be the first examination of licensing of financial advice providers.[4] The study notes that the licensing law resulted in a large reduction in the number of agents in the market, with at least 30 percent of agents exiting, which suggests that the regulations imposed meaningful requirements.[5] These agent exits are exploited by the authors by the authors as a means of identifying the effects of licensing on average quality of services, using pre-versus-post comparisons.

The authors find little evidence of either a beneficial sorting effect or incentive effect of licensing on agent quality. The pre-regulation quality measures of agents who left the market are not significantly different than those of agents who remained in the market after licensing became required. The largest difference between exiting and remaining agents was volume of business, with part-time or less productive agents more likely to exit. Comparing the post- and pre-licensing quality measures for those agents who remained in the market shows only minor evidence of quality improvements. The patterns in the data suggest that consumer search intensity increased as a result of agent licensing, and customers of exiting agents were particularly likely to search. Because exiting agents were not of lower quality than those who remained, and because licensing dramatically reduced the number of agents in the market, the benefits of this search to consumers are unclear.

provision for each service provider develops over time (Darby and Karni 1973; Klein and Leffler 1978). The latter assumption could be relaxed if the licensing authority monitors quality and has the authority to ban a low-quality provider from the market.

[4] Licensing in Germany requires independent insurance agents to meet minimum entry standards that include passing a licensing exam. Agents are required to hold professional liability insurance and to be in good ethical and financial standing, and face standards regarding the advice and information provided to clients.

[5] This estimate is based on a comparison of GDV Annual reports in 2009 and 2010 as reported in Lex et al. (2015).

V. Discussion

Nearly two decades of focus has yielded little progress on improving consumers' financial literacy, at least among adult populations. Academic reviews of the evaluation of financial education programs show at best small effects on knowledge and behaviors (Miller et al., 2014; Collins and O'Rourke, 2010; Willis, 2008). The INFE concludes that "major hurdles to financially capable behaviours appear to lie in the psychological habits, culture, family and social and economic background of individuals as well as on their related perceptions of risks and financial issues" (INFE, 2009, p. 17).

The question of whether regulation of financial advisors can alleviate problems associated with unobservable advice quality is therefore especially important for consumer welfare and for the functioning of consumer financial markets. Consideration of the market problems and proposed regulations shows that the regulatory design problem is fraught with difficulties. In particular, the pressing need for regulatory oversight of financial advice arises from deficiencies in consumer financial literacy that in turn drive the need for financial advice. Many observers correctly note that the quality of financial advice is a credence good for uninformed consumers. This implies that financial literacy and financial advice are complements rather than substitutes (Collins, 2012), and that regulation of the financial advice industry will be insufficient to improve outcomes for vulnerable consumers and investors (Bachmann and Hens, 2015; Schwarcz and Siegelman, 2015). Efforts to create simplified financial products (Bar-Gill and Warren, 2008), bias-free private market rating systems (Meyr and Tennyson, 2015), or government-provided financial information platforms (Schwarcz and Siegelman, 2015) may yield more widespread benefits.

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