How (not) To Pay for (Financial) Advice

Roman Inderst, University Frankfurt (IMFS)

Marco Ottaviani, Northwestern

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Motivation

"Impartial advice represents one of the most important financial services consumers can receive. . . . Mortgage brokers often advertise their trustworthiness as advisors on difficult mortgage decisions. When these intermediaries accept side payments from product providers, they can compromise their ability to be impartial. Consumers, however, may retain faith that the intermediary is working for them and placing their interests above his or her own, even if the conflict of interest is disclosed. Accordingly, in some cases consumers may reasonably but mistakenly rely on advice from conflicted intermediaries."

Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation, US Department of Treasury, June 2009 (page 68)

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- *Reality: Financial advice.*

  – Europe ("Eurobarometer 2003"): More than 90% of customers in, for instance, Austria, Germany or Finland *expect* to receive financial advice. Overwhelming majority *trusts* financial advice.

  – US: 80% of mutual fund investors (outside employer-sponsored plans) receive financial advice (Inv. Company Institute, 2005).

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- Most common form of payment for advice: "Indirect", through commissions or distribution fees that are charged to investment vehicles ("loads").
  −> Likewise, "yield spread" with mortgages.

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- US mutual funds: Bergstresser et al. (2007), Edelen et al. (2008), Chen et al. (2007)
  -> Funds sold through broker /agent networks underperform
  -> Higher fees improve distribution through higher commissions.

Evidence from a Large German Bank

- Hackethal/Inderst/Meyer "The Dark Side of Financial Advice".

- Unique data for *advised* customers combining:

  - Portfolio information over two years. Detailed customer survey.

  - Which products were "incentivized"? Bank's per-customer revenues.

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- Impact of relying on advice? ("strongly")

  - "Incentivized" products in portfolio: 40% compared to average 30%.

  - Per-customer 2-year revenue up by 20% (on average 4.800€).

Rationalizing "Indirect" Payment for Advice

- Possibly fiduciary duty / Liability.

- *(Strategically) "Naive" customers:*
  −> Do not (fully) see/anticipate conflict of interest and its implications.

  – FTC (2008): "many consumers purportedly view mortgage brokers as trusted advisors".

  – Cf. Malmendier/Shantikumar 2007 on analyst following. Gneezy 2005 on (blindly) following/trusting advice. Cain/Loewenstein/Moore 2005 for advice with known conflict of interest. Cialdini 2001 for influence.

Naive Customers

- In equilibrium, *no* direct payment for advice.
  -> Allows to maximally exploit customers' (in equilibrium !) biased perceptions.

- Cap/ban on indirect payments / commissions would

  - increase consumer surplus

  - and potentially social efficiency.

Caveat on Policy Recommendations

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- Alternative policy measure: "Health warning"

  – Rather than disclosure of commissions?

  – Firms' own incentives to disclose?

Baseline Model

- A customer has to choose between two options, $\theta = A, B$.
  -> $A = $ "advanced" (or premium) option.
  -> $B = $ "basic" (or default) option.

- Suitability: Customer types, $\widehat{\theta} = A, B$ -> $v_{\theta,\widehat{\theta}}$.
  -> $v_{A,A} = v_{B,B} = v_h$ and $v_{A,B} = v_{B,A} = v_l$, with $v_h > v_l$

- Prior beliefs: A is "better match" with probability q_0.

Advice

- Intermediary agent: Can *privately* generate better information. At cost $\kappa(e)$.
  $->$ Gives rise to posterior belief q.

- Informativeness/precision: CDF of posterior $G(q \mid e)$
  $->$ Higher e results in mean-preserving rotation

$$\frac{dG(q \mid e)}{de} > 0 \text{ for } q < q_0, \; \frac{dG(q \mid e)}{de} < 0 \text{ for } q > q_0.$$

$->$ "More probability mass in extremes $(q = 0, q = 1)$"

Contracting

Contracting in $t = 1$:

- Product provider A offers advisor fixed T_A and "commission" t_A.

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- Option B of "not purchasing" or "purchasing competitively provided product"

  - t_B just covers "common handling cost" k: $t_B = k$.

  - $p_B = k + c$, where c is "common production cost".

Game of Advice

- $t = 2$: Advisor can set fee for advice $f \geq 0$. Customer can accept contract.

- $t = 3$: Effort e. Observes additional information.
  $->$ Results in posterior $q = \Pr(\theta = A)$.

- $t = 4$: Advisor makes recommendation.
  $->$ We focus, if exists, on informative equilibrium of cheap talk game.

- $t = 5$: Customer decides. Payoffs realized by (risk-neutral) players.

Advisor's Preferences

- "Cost" $\rho > 0$ when customer follows his decision and realizes v_l.
  $->$ Reputational costs, liability, etc.

- If advice is followed, then advisor recommends A if

$$(t_A - k) - (1 - q)\rho \geq (t_B - k) - q\rho.$$

- If interior, then cutoff:

$$q^* := \frac{1}{2} - \frac{t_A - t_B}{2\rho}.$$

Information Acquisition Incentives

- Advisor profits (after transformations)

$$\pi = f + [T_A + t_A - k - \rho\,(1 - q_0)] + 2\rho \int_0^{q^*} G(q \mid e) dq - \kappa(e).$$

- E.g., $e^* = 0$ when $q^* = 0$ or $q^* = 1$.

Serving Naive Customers

- Customer naively anticipates $q^* = \widehat{q}_N := 1/2$ and effort level $\widehat{e}_N > 0$ solving FOC

$$2\rho \int_0^{1/2} \frac{dG(q \mid e)}{de} dq = \kappa'(e).$$

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- Contract design problem with customer: Two constraints

  - *Ex-ante constraint:* Pay $f \geq 0$ up-front.

  - *Interim constraint:* Follow advice (on choice of A).

- Agency contracting: Usage of fixed transfer T_A
  −> Perfect alignment of incentives between product provider and advisor!

Equilibrium with Naive Customers

- Consider increase in p_A (and one-by-one in t_A), together with *compensating* reduction in f:

  –> Marginal change in profits

$$[1 - G(q^* \mid e^*)] - [1 - G(\widehat{q}_N \mid \widehat{e}_N)] > 0.$$

- *Key:* Customer underestimates likelihood of purchasing A!

  –> Unique optimal contract: $f = 0$!

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- *Policy:* Impose $t_A = t_B = k$, leading to $q^* = 1/2$ (and $f > 0$)

  – Customer surplus strictly higher.

  – Social efficiency higher (always when ρ sufficiently small).

Wary Customers

- Have rational expectations about t_A, even when t_A is not observed
  $->$ I.e., that $t_A = p_A - c$.

- Immediate implication: Firms are "residual claimants"
  $->$ Equilibrium choice of (p_A, f) maximizes ex-ante surplus.

- Can still lead to $t_A > t_B$ and thus $q^* < 1/2$ ("biased advice")
  $->$ Key: For $q_0 < 1/2$ this leads to higher effort and thus *overall* higher quality of advice.

Disclosure Policy

- Even a general "health warning" *could* act as an "eye-opener"
  −> Making naive customers wary.

- Implication: Costumer surplus and social efficiency strictly higher.

- Note: Disclosure may not be in firms' own interest when customers are naive.

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