Financial Illiteracy Meets Conflicted Advice: The Case of Thrift Savings Plan Rollovers

John A. Turner
Pension Policy Center
Bruce W. Klein
Pension Policy Center
Norman P. Stein
Drexel University
Financial Literacy Seminar Series
George Washington University
April 23, 2015

Financial Literacy and Financial Advice

- Because many people lack financial literacy they seek financial advice.
- Information asymmetry is inherent in this situation.
- This asymmetry creates a potential for an agency problem, where the agent may not act in the best interest of the client.

Conflicts of Interest

- People seeking advice are likely to encounter an adviser who has a conflict of interest.
- Because of the way the adviser is compensated, the advice that yields the adviser the most income is not the best advice for the client.

Regulation

- Because of the problems in the market for advice, government has instituted regulations in an attempt to protect clients.
- Three approaches have been taken in law to deal with conflicts of interest: prohibition, disclosure and the fiduciary standard.

Fiduciary Standard

- The fiduciary standard requires that the advice be in the best interest of the clients.
- In principle, a fiduciary standard, if it were enforced, would solve the agency problem.

Fiduciary Standard continued

- The fiduciary standard is generally considered the gold standard in regulation of conflicts of interest. It holds the agent to the highest possible standard concerning acting in the interests of the client.
- However, to our knowledge the effect of having a fiduciary standard has never been empirically tested.

Fiduciary Standards

- While the fiduciary standard requires that advisers act in the best interests of their clients, different organizations impose different fiduciary standards, differing in whether conflicts of interest are permitted.

Question

- We have been unable to determine if the SEC fiduciary standard takes into account the fees charged by the adviser.
- For example, would it be possible that advice to roll over by a low-fee adviser would meet the fiduciary standard but the same advice for the same investments by a high-fee adviser would not meet the standard?

Regulatory Capture

- However, because of the large amounts of money at stake in fees, financial advisers attempt to influence the regulator, which when successful is called regulatory capture.

Pension Rollovers

- This paper applies this framework for analyzing advice to the issue of pension rollovers to Individual Retirement Accounts (IRAs).
- IRAs are now the largest source of retirement funds, having overtaken 401(k) plans.
- Few people contribute to IRAs.
- The growth in IRAs is almost entirely due to rollovers.

The Structure of Retirement Income

- Rollovers to IRAs from 401(k) plans, other types of DC plans and DB plans play a key role in determining the structure of retirement income in the United States.
- The amount of money involved makes pension rollovers one of the most important issues in pension policy.

Rollovers and Advice

- Because of the importance of the rollover decision, many people seek financial advice.
- One study (ICI 2015) finds that 61 percent of people with a rollover IRA received financial advice in connection with the rollover.

Thrift Savings Plan

- The Thrift Savings Plan is the 401(k)-type plan for federal government workers, the military and Members of Congress.
- It charges extremely low fees—less than 3 basis points for each of its investment options.

TSP Rollovers

- This paper is about financial advisers advising federal government workers and retirees to roll over from their very low-fee Thrift Savings Plan (TSP) to high fee alternatives.
- The industry average fee for target date funds is more than 30 times higher than the target date funds in the TSP.
- Yet, 18 percent of civilian members of TSP who are separated from TSP say they plan to rollover because of lower fees.

Quality of Advice

- We argue that if we are able to find bad advice where it is least likely, which would be an extremely low fee plan, it is likely in other situations.
- Similarly, we argue that if the financial regulators fail to regulate bad advice where it is least likely, they will likely fail to regulate it in less extreme situations.

Outline

- I will first discuss the previous literature.
- Then I will briefly describe the model we use.
- Next I will describe the Thrift Savings Plan to show why rollovers from it generally are a bad idea.
- I will then discuss two surveys we conducted concerning advice about TSP rollovers from financial advisers with either the suitability standard or the fiduciary standard.

Role of Advice

- We focus on the role of advice as an explanation for rollovers.
- We do not claim that advice is the cause of all TSP rollovers.
- Other reasons that participants give include needing the money for life events, and wanting more flexibility in withdrawal options.

Previous Literature

- Our analysis touches on a number of different areas of economic analysis.
- First, a growing literature, led by Annamaria Lusardi and Olivia Mitchell, has documented the lack of financial literacy. (Among others, see McCarthy and Turner 2000).
- An aspect of financial illiteracy is lack of knowledge as to the fees people pay on their pensions (Turner and Korczyk 2004).

Inertia

- Second, the behavioral economics literature has documented inertia by pension participants (Madrian and Shea (2001), Choi et al. (2002).
- Inertia is the primary justification of the use of defaults, which have become a mainstay of modern pension policy.
- Some more recent literature, using nationally representative data sets, has questioned the strength of inertia (Dushi et al. 2013, Muller and Turner 2013).

Quality of Advice

- A growing literature documents the failure of the market for advice to provide high quality advice in many circumstances (Council of Economic Advisers 2015 provides a survey).
- This literature includes studies where auditors acting as clients have approached advisers to record the advice that they receive (GAO 2013, Mullainathan et al 2012).

Effect of Advice

- Keller et al. (2011) document that advice can have an effect on changing people’s behavior.
- This effect is most likely to occur if people are advised to do something that they already were predisposed to do.

Fee Disclosures

- A study of the Mexican pension system documents the tendency for plan providers to understate the importance of fees in disclosures (Hastings, Hortaçsu, and Syverson 2013).
- An Australian study also documents that advisers often don't mention fees (Australian Securities and Investment Commission 2006).

Fiduciary Standard

- The law and economics literature discusses the use of a fiduciary standard as one way of dealing with conflicts of interest (Sitkoff 2011).
- Our paper is to our knowledge the first to empirically test the effect of a fiduciary standard on the quality of advice.

Regulatory Capture

- Regulatory capture refers to the regulated industry having such a strong influence on the regulator that the regulator protects the interests of the regulated industry rather than the general population.
- The two main regulators for financial advice are the SEC and the Financial Industry Regulatory Authority (FINRA). The Department of Labor recently released a proposed regulation that would have a major impact on advice to pension participants.

SEC Capture

- Woodward (2000) discusses the regulatory capture of the SEC.
- As far as we are able to determine, the SEC and FINRA have never brought a case concerning advice to rollover from the TSP, despite the large difference in fees and the thousands of people who have received that advice.

The Model

- The model is based on the demand and supply for retirement savings vehicles.
- Because pension participants are financially illiterate, they have a derived demand for financial advice when considering whether to rollover from the TSP.

5 Parties

There are five players in the model:

1. Participants, who generally are financially illiterate
2. The TSP plan and its Board, which has argued against rollovers
3. Mutual fund companies and other IRA providers

Parties

4. Financial advisers, some of whom have a suitability standard, some having a fiduciary standard, and all having a conflict of interest

5. Regulators—the SEC, FINRA, and the Department of Labor. The regulated industry attempts to limit the effect of the regulators through regulatory capture.

Summary of the Interactions

- Workers presumably have inertia, which would cause them to not roll over.
- They encounter advertising from the mutual fund industry encouraging rollovers.
- They encounter advice from conflicted financial advisers encouraging rollovers.
- The TSP has started its own campaign discouraging rollovers.

Interactions Continued

- The regulators have a responsibility to protect the interests of those receiving advice.
- The financial advisers attempt to limit the effectiveness of the regulators.

A Puzzle

- The rollovers from the TSP are a puzzle.
- From the perspective of behavioral economics and inertia, the path of least resistance would be to leave the money in the TSP.
- From the perspective of traditional economics, rollovers would not occur because of the generally large difference in fees between the TSP and alternative investment options.

Financial Illiteracy and Conflicted Advice

- A new decision-making model is needed to explain TSP rollovers.
- We argue that model is financial illiteracy with conflicted advice.
- This model is a type of agency problem model.
- This model dominates rational economics and behavioral economics models in that it accurately predicts the opposite of what they predict.

Description of the TSP

- The Thrift Savings Plan (TSP) is the 401(k)-type plan for federal government employees.
- With 4.6 million participants and $412 billion in assets, it is the largest defined contribution plan in the United States.
- A notable feature is its extremely low fees – less than 3 basis points for all its funds, including its international equity fund.

Extremely Low Fees

- While some low fee alternatives are available, a TSP participant rolling over to an IRA will generally pay 20 to 30 times as much in fees, with the difference being substantially larger if a financial adviser is also receiving fees—as much as 70 times greater.

Investment Options

- The TSP offers 5 index funds and 5 target date funds.
- Because of their low fees and income from securities lending, the index funds generally beat their indexes which is something relatively few funds are able to do.
- Thus, in part because of their low fees, the TSP funds provide relatively high net rates of return.

The G Fund

- The G Fund is one of the 5 investment fund options.
- It is invested in special government bonds that are not available to the general public, except through the new MyRA plans.
- This fund has no risk of capital loss with changes in interest rates, making it a great investment for retirees who want low risk.

Inertia has been overcome

- Despite its extremely low fees, favorable rates of return, and advantages of the G Fund, of those TSP participants who separated from service in 2012, by the end of 2013, 45 percent had withdrawn all their funds and closed their TSP account (Long 2014a).

A Lot of Money is Involved

- The total amount rolled over from the TSP to IRAs or other plans in 2013 was roughly $7.2 billion.
- The average TSP rollover was about $150,000.

Roll Ins

- Participants are also allowed to roll in money to the TSP from plans with other employers and from IRAs.
- In 2014, $1 billion was rolled in to the TSP.
- The roll ins suggest that some participants are financially astute and realize that the low fees in the TSP make it a desirable place to hold retirement savings.

Costly Financial Advice

- A survey by the TSP found that in 2013, an estimated 16,400 participants made a withdrawal of all or part of their TSP account because they were advised by their financial adviser to do so.
- That number is about one-third of those making a withdrawal.
- It appears that a person rolling over the average amount could be paying $20,000 more in present value of fees, including the fees of the adviser.

Our Focus

- We focus on the advice received by TSP participants as an explanation for their rollovers.
- We have chosen this focus because the extremely low fees the TSP charges provide a strong test as to the quality of financial advice people receive.

The Market for Financial Advice

- At least among pension participants, we argue that the market for financial advice is characterized by financially illiterate consumers on the demand side and (in the U.S.) conflicted advice on the supply side.

Conflicted Advice

- Conflicted advice means that the adviser has a financial conflict of interest when providing advice.
- This conflict tends to result in advice that is not in the best interest of participants.

Generalized Advice

- In addition, TSP participants presumably are affected by the financial industry campaign to “Roll over your ‘old’ 401(k) plan.”
- This generalized advice, repeated many times, provides a mind set favorable to rollovers.
- The unanimity of advice from different financial service providers adds to its credibility.

Financially Illiterate Consumers

- An aspect of financial illiteracy is that consumers do not know how much of a difference in outcomes a difference in fees makes.
- For this reason, as TSP rollovers demonstrate, they are insensitive to even large differences in fees.
- Financial advisers presumably are aware of this insensitivity to differences in fees and use it to their advantage.

Convenience Sample Survey

- To learn more about the advice that TSP participants receive, we conducted two small convenience sample surveys.
- The first survey covers 15 major financial adviser companies.
- We believe that all or most of these advisers were subject to the suitability standard.
- This survey covered major financial advisers who provided call-in numbers over the internet. It also included some for whom we obtained telephone numbers from the Washington, DC yellow pages.

Scenario

- Rather than presenting an artificial scenario to the advisers, we presented the actual situation of one of the authors who is a participant in the TSP based on previous federal employment.
- He asked for advice as to whether he should roll over his own account or stay with the TSP.

Survey Results

- One adviser, Vanguard, indicated that if the person were highly risk averse, he should stay with the TSP because of the government bond fund (the G Fund) because it does not fluctuate in value with changes in interest rates.
- Four advisers declined to provide advice but indicated that they had more investment offerings than the TSP and felt that they would be a good option.

Survey Results CONTINUED

- 10 of the 15 advisers recommended rolling over to an IRA.
- Thus, the preponderance of advisers provided bad advice.
- We can say unequivocally that the advice was bad advice because we know the details of the person receiving it.

False Information

- Some of the information we received was inaccurate.
- For example, one adviser said we would pay lower fees if we rolled over and one said we could purchase lower-priced annuities through them.

Know Your Client

- Generally, the advisers made little effort to find out information about the client and instead focused on the advantages of a rollover.

Fiduciary Standard

- We also conducted an email survey of 15 advisers who had a fiduciary standard for their advice.
- This survey differed slightly in that instead of presenting a single scenario, we indicated that we were doing a survey and asked what their advice would be.
- This survey allows us to test whether having a fiduciary standard makes a difference in the advice provided.

Our Hypothesis

- Our hypothesis: Because of the extremely low fees of the TSP and adequate choice of investments, advisers with a fiduciary standard would either advise not to roll over or would advise generally not to roll over.
- The null hypothesis is that there is no difference in the advice provided.

Results

- Of the 15 advisers surveyed:
- 4 advised not to roll over
- 9 advised to roll over in some circumstances
- 2 advised to roll over (compared to 10 in the previous survey).
- Thus, most indicated that they would advise to roll over in some circumstances.

Why is the effect of the fiduciary standard so weak?

- Because it is our conclusion that in most circumstances a rollover would not be advisable, the results are weaker than we expected.
- For those saying they would advise to roll over in some circumstances, we do not know how likely it is that they would advise to roll over.

Statistically Significant

- Nonetheless, because the number unequivocally recommending a rollover is substantially lower in the second survey, based on a chi square test, the responses are significantly different from those in the first survey at the 2.5 percent level.

Biases

- The email survey may be biased relative to the phone survey in that advisers more be less likely to give “bad” advice when it is in writing than over the phone.
- It may also be biased because we frame it as a survey rather than as an actual client inquiry, so the advisers may be less aggressive in recommending rollovers.

Biases continued

- Both biases are in the direction of not recommending a rollover. Thus, our finding of a weak difference may overstate the actual difference in advice received.

Conflict of Interest

- It appears that having a conflict of interest still affects the quality of the advice, even for advisers with a fiduciary standard.
- To be specific, the fiduciary standard is the SEC standard.
- It also appears that weak regulatory oversight by the SEC may play a role.

SEC Standard

- It appears that the SEC assumes that investors are sophisticated and that disclosure of fees is all that is required.
- A rollover could not be in the interest of the client because of the higher fees, but it appears that, at least in practice, would not violate the SEC standard.

Half Truths

- The advisers in both surveys generally said that the advantage they offered was many more funds than the TSP provides—which is a true statement.
- The issue of their much higher fees was not raised, so they did not provide all the relevant information.

The argument they make

- Advisers need to have an argument as to why to roll over, and the most common one is that the TSP only has 5 basic investment options, while they can offer many options.
- This argument is a true, but it does not weigh the marginal benefit of further diversification for an already well diversified portfolio vs the high costs of leaving the TSP.
- It thus appears they do not weigh the cost of their advice.

Incomplete Advice

- It appears that advisers tend to focus on the benefits of their advice—in this case greater diversification—without weighing the marginal benefits against the marginal costs.
- The advisers use self-interested analysis to justify self-interested advice.

The Regulators

- SEC regulates registered investment advisers.
- FINRA regulates broker-dealers.
- The states regulate insurance companies.
- DOL has responsibility for regulation relating to ERISA plans.
- The Consumer Financial Protection Board is explicitly excluded from regulating retirement products.

Conclusions

- We argue that the market for financial advice is characterized by financially illiterate consumers meeting conflicted advice.
- Traditional economics and behavioral economics are unable to explain TSP rollovers, while our version of an agency model is able to explain the rollovers.
- Many consumers are insensitive to large differences in financial market fees.

Conclusions 2

- While inertia, as well as traditional economics, would indicate that TSP participants would not roll over to mutual funds with fees 20 or 30 times as high, we argue that inertia has been overcome by bad advice from financial advisers, as well as by the generalized advertising campaign encouraging pension rollovers.

Conclusions 3

- We document that having a fiduciary standard does affect the quality of advice, but the effect is weaker than we anticipated.
- Having a conflict of interest still appears to affect the quality of advice.
- It appears that frequently advisers with a fiduciary standard in our survey did not weigh the benefits of their advice against its costs.

Conclusions 4

- To our knowledge, the SEC and FINRA have never pursued a case of someone being recommended to rollover from the TSP with its extremely low fees to a high-fee alternative.

Conclusions 5

- We argue that the financial advice we document concerning TSP rollovers demonstrates how low the standard for financial advice is in the United States.
- In the United Kingdom, this type of advice is called “pension mis-selling,” and is considered to be a scandal.