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Views on Department of Labor’s Proposed Conflict of Interest Rule - Oral Statement

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Oral Statement of

Anthony Webb
Senior Research Economist,
Center for Retirement Research at Boston College

“Hearing on Proposed Conflict of Interest Rule and Prohibited Transaction Exemptions”
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The views expressed are solely those of the author and do not represent the views or policy of the Center for Retirement Research at Boston College.
Thank you for inviting me. It is my pleasure to be here.

Since the Employee Retirement Income Security Act (ERISA) was passed in 1974, the retirement savings landscape has been transformed. Most private sector workers – if they have a retirement plan – are covered by a 401(k), where the participant is responsible for investment allocation and drawdown decisions. Furthermore, most defined contribution assets are actually not even in 401(k) plans – they are in Individual Retirement Accounts (IRAs), where investors are not accorded ERISA protection.

We face a retirement saving crisis. Research by the Center for Retirement Research shows that more than half of working-age households will not be able to maintain their standard of living in retirement.¹ Many factors have contributed to the crisis. But high fees and sub-par investment returns have played a significant role.

Even seemingly small differences in investment returns cumulate to large amounts over time. Some simple math shows that a one-percentage-point annual reduction in investment returns reduces retirement assets by about one fifth at retirement.²

A recent report by the Council of Economic Advisers estimated that conflicted advice reduced investment returns by about one percentage point and that about $1.7 trillion of assets was subject to conflicted advice, resulting in a loss of about $17 billion a year.³ To put this number in context, it is between one quarter and one third of the tax expenditure on 401(k) and IRA plans.

I believe that the Council of Economic Advisers’ number is in the right ballpark, but probably a little low – for three reasons. First, it excludes assets in 401(k) plans. Many plans are great, but some have high fees and poor investment options.

¹ Munnell, Hou, and Webb (2014).
² This example assumes that a household begins investing at age 25 and retires at 65. The household earns a 4.5 percent rate of return in the base case and a 3.5-percent return in the alternative.
Second, about $600 billion of the $1.7 trillion is invested in variable annuities where fees can be much higher than one percentage point. Third, it also excludes advised assets other than load mutual funds and annuities. Research shows that investors in brokerage accounts also suffer from conflicted advice. Although fees overall have been trending down, the $17 billion should be viewed as a lower-bound estimate.

So we have a big problem that needs to be addressed. But we want to address it in the cheapest and least intrusive way. One approach would be to mandate greater disclosure. I have nothing against greater disclosure, but I don’t see it as working on its own. Many academic studies have shown low levels of financial literacy. It is simply asking too much to expect people to read the disclosures, understand them, figure out what action to take, and then implement their decision.

Since disclosure alone won’t work, we need regulation. Let me say a few words about the structure of the proposed regulation. First, it replaces the existing five-part test for determining fiduciary status by a new four-part test. The regulation applies this test not only to 401(k)s, but also to IRAs and IRA rollovers. Second, it creates six carve-outs. If you fall within one of the carve-outs, you will not be deemed to be a fiduciary. Finally, the regulation creates exemptions, the most important of which is the Best Interest Contract (BIC) exemption. The BIC exemption permits fiduciaries to receive commissions, subject to conditions designed to safeguard investors.

I strongly support the new four-part test. The old five-part test was a broken reed in that advisors could easily escape fiduciary status by claiming that there was no mutual understanding that the advice should form the primary basis of the investor’s decisions.

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4 See, for example, Lusardi and Mitchell (2011).
I also strongly support the decision to apply the proposed regulation to both IRAs and rollovers into IRAs. Most money in IRAs consists of 401(k) rollovers, so these accounts are an integral part of the retirement system. On job change, the household’s best option is often to leave its money in its 401(k) rather than to roll it over into an IRA. But advisors, of course, have an incentive to recommend a rollover. Under the proposed regulation, advisors will only be able to recommend a rollover when it is in the household’s best interest, not when it is merely “suitable.”

While carve-outs mostly cover situations in which fiduciary status would not be appropriate, I have serious concerns with the carve-out for platform providers. Research shows that mutual fund families acting as trustees for 401(k) plans favor their own affiliated funds, particularly their poorly performing funds, to the detriment of plan participants.\(^5\) I would favor eliminating the carve-out. As an alternative, the United States could either follow U.K. practice and prohibit platform providers from receiving fees, or alternatively create an exemption similar to that applied to broker-dealers. Another alternative would be to restrict the carve-out to platforms servicing large plans. And the carve-out should definitely not be extended to platforms servicing IRAs, where protections are weaker.

I will now move on to the part of the regulation that has led to the loudest protests from the financial services industry – the BIC exemption. Can I start by saying that, in contrast to what has happened in other countries, this effort is very much light-touch regulation. The argument could be made that we should have followed the example of others and eliminated sales commissions altogether. But officials at the Department of Labor made a judgment call that they could secure their objective through less intrusive regulation, and I support their decision.

Some parts of the industry argue that the BIC exemption is unworkable and will lead to advisors abandoning large segments of the population and pushing others into

\(^5\) Poole, Sialm, and Stefanescu (2015 forthcoming).
more expensive fee-based advice. If you are willing to make really extreme assumptions about the number of people who might lose access to advice and about the value of that advice, it is easy to show that the cost of the regulation will exceed the benefits.

But these assumptions are simply not credible. We are being asked to believe that the terms of the BIC exemption are so burdensome, so onerous, that the industry will choose to walk away from $1.7 trillion of assets and perhaps $17 billion of revenue rather than comply with them.

What the industry characterizes as insuperable obstacles are, to my mind, just minor wrinkles. Let me give you one example. The exemption requires the adviser to disclose the fees on an investment over a holding period. The industry argues that making such an estimate is impossible because: 1) the cost depends on the return and the holding period, neither of which is known in advance; 2) different companies would be making different assumptions; and 3) any assumptions might conflict with FINRA guidelines. All of these concerns are valid. But these problems are not insoluble. One might, for example, require companies to use “reasonable” assumptions. In this, as in other areas, the BIC exemption would benefit from tweaking. But the overall structure is correct.

So to summarize, I view the proposed regulation as a carefully crafted attempt to address a serious problem. I think that the Department of Labor has struck a nice balance between doing enough to be reasonably certain of improving conduct and not doing so much that it limits consumers’ choice as to how they receive financial advice.

Thank you for your time.
References


