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Agenda

Advancing economics in business

Retail financial advice: is anybody listening?

Recent developments in behavioural economics and a growing academic literature on the role of financial advice have cast some doubts on the effectiveness of both information and advisers in improving the decision-making of retail investors in financial markets. This article summarises some of this literature and highlights where additional research could be undertaken on the nature of the relationship between financial adviser and customer

The process through which retail investors buy and sell financial products, and through which the information and financial advice is made available to them, has been subject to much regulatory attention.[1] At the European level, a stated objective of the Markets in Financial Instruments Directive (MiFID) is to ensure that retail investors have sufficient information to enable them to make informed choices.[2] The Directive now also includes investment advice in the core list of 'investment services and activities', and firms providing such advice fall within the scope of MiFID.

In the UK, the provision of advice is being reviewed as part of the Financial Services Authority's Retail Distribution Review (RDR). The objectives of this review are to:

– ensure that there is more clarity on products and services offered to consumers;
– ensure that their needs and wants are addressed;
– maintain high standards of professionalism within the industry;
– ensure that effective remuneration arrangements are in place for market participants;
– enhance the viability of firms and encourage the fair treatment of consumers;
– ensure an effective regulatory framework that does not impair innovation.

As regards advice, the RDR interim report recommended the clear separation of advice from sales, the need to ensure the independence and professionalism of advisers, and the need to ensure that consumers are recommended products from across the whole market.[3] The overall aim is that consumers of retail financial products should be given the most appropriate and effective advice when making their investment decisions.

However, the provision of information and advice alone does not necessarily imply that consumers will act on it and, even if they do, it still does not imply that they will make the most appropriate investment decision for their particular circumstances.

Various studies have shown that, when it comes to financial decision-making, consumers are limited in their use of formal, independent advice channels. The FSA's own financial capability survey revealed that only 14% of respondents used an independent financial adviser or broker as the main source of information for their product purchase, and 79% relied on product information and/or non-independent advice when choosing a product.[4]

In addition, a growing body of academic literature has questioned the effectiveness of financial advice for retail consumers. This literature draws on behavioural economics and psychology to identify the factors that lie behind and influence individual decision-making, with a view to determining the role of advice in this process. Although this literature tends to focus on the behaviours of consumers, it is also important to consider the behavioural traits of advisers that may affect consumers' ability to make rational decisions.

This article provides an overview of some of these issues. It sets out the role of financial advice, provides a brief overview of some of the recent academic literature insofar as it relates to the impact of advice on individual decision-making, and suggests areas where further research may be necessary.

Although the RDR is concerned only with distribution arrangements in the UK, a deeper understanding of the role of financial advice and its importance is relevant for financial regulators in any country in which retail financial products are marketed and distributed. It is rarely the case that a financial decision is made by an individual in isolation. The nature of the advice may take different forms, and the way in which it is used may vary across cultures. However, as long as there is some form of interaction between providers of products, consumers and third parties offering advice, there is a need for a better understanding of the process and the mechanisms involved in decision-making.

The role of advice in retail financial services

Consumers of retail financial products face a series of complex investment decisions. They must plan over long but finite time horizons, and they can choose from a wide variety of financial assets, which vary in liquidity, time horizons and risk–return profiles, and which may differ in their tax implications. Moreover, consumers have a number of sources of wealth which can be used for investment purposes. In addition to regular income streams, these include borrowing, inherited wealth and other unexpected sources of income such as redundancy payments and the release of equity from house sales.

At the same time, there is a concern about the levels of financial capability among many consumers, which magnifies the already existing informational problems that they face. This knowledge constraint is underpinned by an additional time constraint—even if financial capability could be enhanced for most consumers, few of them are likely to have the time available to fully evaluate all of the products on offer and their alternative outcomes.

Policy-makers and regulators in the UK and elsewhere have concentrated on improving the information available to consumers through enhanced disclosure requirements which are aimed at reducing the apparent complexity of products and, hence, the time taken to evaluate them. There has also been a recent focus on measures to improve financial capability and awareness through a series of government- and industry-led initiatives.

However, a recent paper by De Meza, Irlenbusch and Reyniers (2008) has cast doubts on the effectiveness of these schemes.[5] The authors argue that consumers exhibit a series of cognitive and behavioural characteristics that influence them in all aspects of their lives and that can help to explain the sub-optimal financial decisions that are often made. These characteristics and traits are well known in the behavioural economics literature and include the following.

– **Procrastination**—for example, the urge for instant gratification may lead people to not make decisions (or to postpone or not take actions) which are in their long-term interests.

– **Loss or regret aversion**—the tendency to weigh losses more than gains (eg, resulting in a reluctance to sell at a loss). In addition, people may be regret-averse and avoid making decisions that they fear they could subsequently regret.

– **Mental accounting**—the tendency for people to group their assets into a number of non-fungible accounts and use these accounts for different purposes (eg, patterns of expenditure of unexpected winnings or bonuses differing from that of other income).

– **Status quo bias**—the reluctance of people to change strategies or behaviours or to consider new options.

– **Curse of knowledge**—when too much information deflects attention from what is really important and results in less-optimal decision-making.

– **Cognitive biases**—such as ‘rules of thumb’ decision-making and heuristics.

De Meza, Irlenbusch and Reyniers (2008) conclude by recommending that these biases need to be recognised, but even before this can be done there is a need to overcome the bias against recognising one’s own biases.

If this is indeed the case, it could be that financial advisers have a vital role to play, first in helping consumers to recognise their biases, and then in assisting them in overcoming these biases and improving their decision-making. This implies a somewhat new and enhanced role for financial advisers that goes beyond the role of overcoming consumers’ informational problems and knowledge constraints.

The question is: what evidence is there that advisers actually deliver on this role—ie, what is the quality of advice given, and do consumers follow this advice and make more suitable investment decisions? A review of the literature suggests a lack of research on these questions.

Academic literature on financial advice

Although a relatively new area of research, there is an extensive body of literature on the role of advice in decision-making at the general level, as reviewed in Bonaccio and Dalal (2006).[6] The literature has been concerned with how those receiving advice react to it in terms of their decision-making and what factors determine their responsiveness to advice. Despite some inconclusiveness in the findings, the importance of certain key recurring factors has been noted. These include the perceived experience of the adviser, the degree of trust held in the adviser, the perceived quality of advice, the existence of performance-contingent rewards, and the degree to which the adviser shows confidence in their recommendations. However, little appears to be known about the relative importance of these factors, and this is an area where further research appears warranted. Importantly, the conclusion drawn by Bonaccio and Dalal is that, overall, individuals appear much less willing to act on advice than would be expected.

One interesting aspect of the existing research, noted by the authors, is that it tends to view advice as comprising a recommendation. However, more attention is now being paid to a broader view of advice in which it is regarded as assisting an individual in making more effective decisions by helping them to assimilate new information, organising their thoughts, and giving them more confidence in their decisions.

The above literature has looked at advice in general, rather than taking account of the specific characteristics of financial advice. Although there is an extensive literature on the role of intermediaries in the financial sector, the assessment of actual financial decision-making by consumers has received less attention, and the role of financial advisers as a specific form of intermediary even less.

In his presidential address to the American Finance Association, Campbell (2006) reviewed the theoretical and empirical aspects of what he termed 'household finance'.[7] He noted various anomalies in participation rates by individual investors in risky asset classes and in decisions on how to allocate wealth between available asset classes. However, he did not analyse the role of financial advisers in this market specifically.

An attempt to remedy this gap in the academic literature was provided by Fischer and Gerhardt (2007).[8] One of the first problems they encountered was that there is no clear definition of what constitutes financial advice. The definition they use for advisers is a rather broad one since it refers to a person or organisation offering professional financial expertise to individuals seeking assistance or wishing to delegate all responsibility for investment decision-making. This broad definition appears to include what in the UK is referred to as advice as well as financial sales and discretionary wealth management.

Having established a definition for financial advisers, Fischer and Gerhardt go on to assess their role as intermediaries between consumers of retail financial products and capital markets—serving to reduce frictions and lower transactions costs. Advisers do this by mitigating the information asymmetry that exists between consumers and product providers.

In order to do this effectively, the relationship must be characterised by appropriate incentive structures to ensure that advisers do act in the best interest of consumers as opposed to maximising their own utility or that of the provider whose products they may be recommending.

Fischer and Gerhardt also propose an additional role for advisers in terms of mitigating some of the behavioural characteristics and biases, referred to previously, which may result in sub-optimal outcomes for consumers. To be effective in this role, the authors suggest that advisers need to make consumers aware of the biases to which they are subject. In order to do this, of course, they have to overcome the initial bias against recognition. Although Fischer and Gerhardt speculate that this may be a role advisers could play, they also acknowledge that there is as yet no evidence that this is currently the case and, even if it were, advisers' effectiveness in this role is yet to be proven.

In addition, there is the problem that advisers themselves may be subject to similar behavioural characteristics and biases that also affect their clients. To mitigate these, it is necessary to ensure that professional standards and training programmes can enable advisers to recognise such behaviours and act accordingly.

The overall conclusion from the literature is that there is a need for a rigorous analysis of the nature of the relationship between advisers and their clients, which takes account of the behavioural characteristics and biases pertaining to both, with a view to determining their impact more conclusively and assessing what the best policy response would be to mitigate these effects if they are found to be detrimental.

Concluding remarks

The RDR is likely to result in a new model for the way in which financial advisers are categorised and remunerated, and to recommend changes to professional qualifications required by advisers. There may be a clearer distinction between advice and sales, and the role of commissions in providing income for advisers could become less important.

However, the RDR does not include a fundamental review of the role of financial advice. Neither does it appear to be taking account of some of the behavioural issues highlighted in this article. Therefore, even if an incentive structure does emerge that, in theory, serves to change the behaviour of financial advisers resulting in better outcomes for consumers (all other things being equal), it may still not be the case that consumers' financial decision-making improves and necessary longer-term saving and investment decisions are made. The inherent behavioural characteristics of both consumers and advisers may prevent this.

Gaining a clearer understanding of these issues would require an assessment of the role of financial advice, drawing on the literature that considers both the impact of advice in general terms and the effectiveness of financial advice in particular. A key aspect of this would be to consider the actual impact of financial advice both on consumer behaviour and, if the advice does change behaviour, on the outcomes experienced by consumers. Such an analysis should take account of the different roles that an adviser may fulfil, and should also consider more precisely what is meant by financial advice.

There may be important policy implications if it were found that inherent behavioural characteristics and biases led to inappropriate advice being given, or any form of advice—appropriate or otherwise—not being acted on. The role of financial advisers may need to be viewed differently. Furthermore, the effectiveness of financial capability programmes and financial promotions may need to be reassessed so that they complement the advice that is being given as far as possible. Without a better understanding of the relationship between adviser and consumer and the behaviours that underpin it, regulatory initiatives such as the RDR in the UK may not deliver the intended outcomes in the market.

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[1] See also Oxera (2008), 'Financial (il)Literacy: Do Consumer Education Programmes Work?', *Agenda*, March; and Oxera (2008), 'Myopia or Yours? How Pension Reform Can Encourage Saving for Retirement', *Agenda*, April. Available at www.oxera.com.
[2] Directive 2004/39/EC.
[3] Financial Services Authority (2008), 'Retail Distribution Review: Interim Report', April.
[4] Financial Services Authority (2006), 'Levels of Financial Capability in the UK: Results of a Baseline Survey', March.
[5] De Meza, M., Irlenbusch, B. and Reyniers, D. (2008), 'Financial Capability: A Behavioural Economics Perspective', Financial Services Authority Consumer Research Paper 69, July.
[6] Bonaccio, S. and Dalal, R.S. (2006), 'Advice Taking and Decision Making: An Integrative Literature Review and Implications for the Organizational Sciences', *Organizational Behavior and Human Decision Processes*, **101**, pp. 127–51.
[7] Campbell, J.Y. (2006), 'Household Finance', *Journal of Finance*, **61**:4, pp. 1553–604.
[8] Fischer, R. and Gerhardt, R. (2007), 'The Missing Link between Investors and Portfolios: Introducing Financial Advice', E-Finance Lab, Frankfurt Am Main, Working Paper, August.