Statement of Martin Neil Baily[1] to the Public Hearing Concerning the Department of Labor's Proposed Conflict of Interest Rule

Tuesday August 11, 2015, Panel 10

Introduction

I would like to thank the Department for giving me the opportunity to testify on this important issue. The document I submitted to you is more general than most of the comments you have received, talking about the issues facing retirement savers and policymakers, rather than engaging in a point-by-point discussion of the detailed DOL proposal.

Issues around Retirement Saving

1. Most workers in the bottom third of the income distribution will rely on Social Security to support them in retirement and will save little. Hence it is vital that we support Social Security in roughly its present form and make sure it remains funded, either by raising revenues or by scaling back benefits for higher income retirees, or both.

2. Those in the middle and upper middle income levels must now rely on 401k and IRA funds to provide income support in retirement. Many and perhaps most households lack a good understanding of the amount they need to save and how to allocate their savings. This is true even of many savers with high levels of education and capabilities.

3. The most important mistakes made are: not saving enough; withdrawing savings prior to retirement; taking Social Security benefits too early[2]; not managing tax liabilities effectively; and failing to adequately manage risk in investment choices. This last category includes those who are too risk averse and choose low-return investments as well as those that overestimate their own ability to pick stocks and time market movements. These points are discussed in the paper I submitted to DoL in July. They indicate that retirement savers can benefit substantially from good advice.

4. The market for investment advice is one where there is asymmetric information and such markets are prone to inefficiency. It is very hard to get incentives correctly aligned. Professional standards are often used as a way of dealing with such markets but these are only partially successful. Advisers may be compensated through fees paid by the investment funds they recommend, either a load fee or a wrap fee. This arrangement can create an incentive for advisers to recommend high fee plans.

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[1] Baily's work has been assisted by Sarah E. Holmes. He is a Senior Fellow at the Brookings Institution and a Director of The Phoenix Companies, but the views expressed are his alone.

[2] As you know, postponing Social Security benefits yields an 8 percent real rate of return, far higher than most people earn on their investments. For most of those that can manage to do so, postponing the receipt of benefits is the best decision.

5. At the same time, advisers who encourage increased saving, help savers select products with good returns and adequate diversification, and follow a strategy of holding assets until retirement provide benefits to their clients.

Implications for the DoL's proposed conflicted interest rule

1. *Disclosure.* There should be a standardized and simple disclosure form provided to all households receiving investment advice, detailing the fees they will be paying based on the choices they make. Different investment choices offered to clients should be accompanied by a statement describing how the fees received by the adviser would be impacted by the alternative recommendations made to the client.

2. *Implications for small-scale savers*. The proposed rule will bring with it increased compliance costs. These costs, combined with a reluctance to assume more risk and a fear of litigation, may make some advisers less likely to offer retirement advice to households with modest savings. These households are the ones most in need of direction and education, but because their accounts will not turn profits for advisors, they may be abandoned. According to the Employee Benefits Security Administration (EBSA), the proposed rule will save families with IRAs more than $40 billion over the next decade. However, this benefit must be weighed against the attendant costs of implementing the rule. It is possible that the rule will leave low- and medium-income households without professional guidance, further widening the retirement savings gap. The DoL should consider ways to minimize or manage these costs. Options include incentivizing advisors to continue guiding small-scale savers, perhaps through the tax code, and promoting increased financial literacy training for households with modest savings. Streamlining and simplifying the rules would also help.

3. *Need for Research on Online Solutions.* The Administration has argued that online advice may be the solution for these savers, and for some fraction of this group that may be a good alternative. Relying on online sites to solve the problem seems a stretch, however. Maybe at some time in the future that will be a viable option but at present there are many people, especially in the older generation, who lack sufficient knowledge and experience to rely on web solutions. The web offers dangers as well as solutions, with the potential for sub-optimal or fraudulent advice. I urge the DoL to commission independent research to determine how well a typical saver does when looking for investment advice online. Do they receive good advice? Do they act on that advice? What classes of savers do well or badly with online advice? Can web advice be made safer? To what extent do persons receiving online advice avoid the mistakes described earlier?

4. *Pitfalls of MyRA.* Another suggestion by the Administration is that small savers use MyRA as a guide to their decisions and this option is low cost and safe, but the returns are very low and will not provide much of a cushion in retirement unless households set aside a much larger share of their income than has been the case historically.

5. *Clarifications about education versus advice*. The proposed rule distinguished education from advisement. An advisor can share general information on best practices in retirement planning, including making age-appropriate asset allocations and determining the ideal age at

which to retire, without triggering fiduciary responsibility. This is certainly a useful distinction. However, some advisors could frame this general information in a way that encourages clients to make decisions that are not in their own best interest. The DoL ought to think carefully about the line between education and advice, and how to discourage advisors from sharing information in a way that leads to future conflicts of interest. One option may be standardizing the general information that may be provided without triggering fiduciary responsibility.

6. *Implications for risk management*. Under the proposed rule advisors may be reluctant to assume additional risk and worry about litigation. In addition to pushing small-scale savers out of the market, the rule may encourage excessive risk aversion in some advisors. General wisdom suggests that young savers should have relatively high-risk portfolios, de-risking as they age, and ending with a relatively low-risk portfolio at the end of the accumulation period. The proposed rule could cause advisors to discourage clients from taking on risk, even when the risk is generally appropriate and the investor has healthy expectations. Extreme risk aversion could decrease both market returns for investors and the "value-add" of professional advisors. The DoL should think carefully about how it can discourage conflicted advice without encouraging overzealous risk reductions.

The proposed rule is an important effort to increase consumer protection and retirement security. However, in its current form, it may open the door to some undesirable or problematic outcomes. With some thoughtful revisions, I believe the rule can provide a net benefit to the country.