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[Department of Labor Needs to Carefully Balance Its Proposed Conflict of Interest Rule; Financial Advisors Can Both Help - and Hurt - Consumers, Brookings' Baily Finds]

Rule could widen the retirement savings gap by leaving low- and medium-income households without professional guidance

The Department of Labor's proposed conflict of interest rule, designed to prevent consumers from being harmed by requiring their financial advisers to disclose compensation they might receive from selling certain retirement plans and make those advisers liable for losses, can help resolve some of the problems facing American savers, but the rule needs further work, according to a new paper by Brookings Senior Fellow Martin Neil Baily and Research Assistant Sarah E. Holmes. As it stands, the rule could have the unintended consequence of widening the retirement savings gap between the wealthy and the low- and middle-class, leaving those who need professional guidance the most without that help.

Baily and Holmes note that while Americans are living longer and thus have ever-increasing retirement needs, most workers remain woefully underprepared financially for life in retirement. While surveys have shown workers themselves estimate that they will need to accumulate $1 million in savings by the time they retire, few get anywhere close to that, with the median retirement savings for a worker over age 60 being just $172,000. Americans often lack the financial literacy needed to make sound decisions about their retirement, which is why many seek out financial advisors to guide them. While these advisors offer many benefits to consumers, they don't always act in the best interests of their clients, the authors write in analyzing the DOL's proposed rule.

In "Serving the Best Interests of Retirement Savers: Framing the Issues," Baily and Holmes consider four key goals for savers to achieve retirement security: saving enough and spending sensibly; making age-appropriate investments; avoiding fraud and excessive fees; and minimizing tax liability. They note that professional advice can help savers stay on track and put their savings to work, but they also acknowledge that savers with IRA accounts may receive poor investment recommendations from their advisors, and worry that in many cases, the choice that is best for the consumer is not the best for the advisor's bottom line -- with the mismatch having complex results. The authors compare retirement security to matters pertaining to health, cars, and legal status. "We typically defer to our doctors, our mechanics, and our lawyers [in such matters], rather than attempting to puzzle through the problems ourselves," they write. However, "when consumers lack knowledge about where their money is going, problems can ensue."

Advisors can offer their clients many advantages, such as setting reasonable savings goals, avoiding fraudulent investments and mistakes like buying high and selling low, and determining the right level of risk for a particular household, they note. On the other hand, these same advisors are often incentivized to choose funds that increase their own financial rewards, and the nature and amount of fees received by advisors may not be transparent to their clients -- and small-scale savers may not be able to access affordable advice at all.

In many ways, the DOL's proposed rule is well-intended to help protect Americans by establishing a fiduciary relationship between advisors and clients. However, the authors worry that the proposed rule might leave low- and medium-income households without professional guidance, further widening the

retirement savings gap. The proposed rule will bring with it increased compliance costs, they note, which combined with a reluctance to assume more risk and a fear of litigation, may make some advisors 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 tum profits for advisors, they may be abandoned. In order to minimize or manage that downside, the authors suggest that DOL offer advisors an incentive to work with small-scale savers, and promote increased financial literacy training. Baily and Holmes also stress that the distinction between education and advice is not clear enough in the proposed rule, and encourage DOL to close any potential loopholes by standardizing the general educational information that advisors can provide without triggering fiduciary responsibility.

The rule may encourage excessive risk aversion in some advisors, they add. 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. Baily and Holmes suggest that DOL 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," Baily and Holmes conclude, "but in its current form it may open the door to some undesirable or problematic outcomes. With some thoughtful revisions, we believe the rule can provide a net benefit to the country."

Read the full paper

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