Ethics and Trust in the Market for Financial Advisors

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Introduction

- Market for Financial Advice is large $>$ \$145 trillion by 2025 (PWC).
- But little trust:
  - 7% advisors with misconduct record.
  - 27% of these are repeat offenders.
  - Payouts average $>$ \$$\frac{1}{2}$m (Egan et al. 2019).
- Yet financiers some of best paid professionals in the economy (Philippon and Reshef, 2012)

- We study trust, pay and misconduct in the financial advisory market, and address:
  1. Why is trust low while for some financiers pay is high?
  2. Who would buy from blemished advisors?
  3. Will changes in the distribution of wealth make misconduct worse?

Our Main Contribution

- A theoretical model of the labour market for financial advisors. OLG with ethics and a regulator.
- Market clearing implies that those with little *smart money* (wealth $\times$ sophistication prob) use blemished advisors.
- As the rich get richer, or wealth levels grow, advisor pay $\uparrow$ but trust in advisors $\downarrow$.
- Industry rehires some blemished advisors – but as society wealth rises we predict this becomes rarer.
- And misconduct (proportion of deliberately wrong investment decisions) $\downarrow$ as wealth (of all or just richest) increases.

Literature Review

- Misconduct amongst financial advisors is significant: Egan, Matvos, and Seru (2019), Dimmock, Gerken, and Graham (2018), Law and Zuo (2021), Yimfor and Tookes (2021), Parsons, Sulaeman, and Titman (2018).
- Career concerns and investment decisions; focuses on *sharing-the-blame*: E.g. Guerrieri and Kondor (2012) – unethical removed from market, Scharfstein and Stein (1990), Zwiebel (1995), Dasgupta and Prat (2008).
- Models without career concerns: Thanassoulis (2022), Inderst and Ottaviani (2009), Carlin and Gervais (2009), Zhou, Keppo, and Jokivuolle (2020).
- Principal-agent models, w/out market: Bénabou and Tirole (2006, 2011), Kartik (2009).
- Firm reputation effects without career concerns & regulator interaction: Mailath and Samuelson (2001), Board and Meyer-ter-Vehn (2013).
- Trust in financial advisors: Sapienza and Zingales (2012), Limbach, Rau, and Schürmann (2020).

The Model

Model Overview

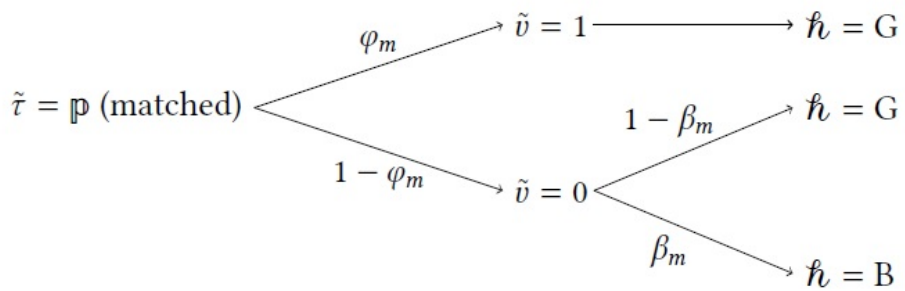
- A population of clients require a financial advisory firm to access particular financial products (*unit mass*).
- Each client has access to one advisory firm – firm a price setter.
- Firm requires a financial advisor to supply the service.
- Financial advisors – unobserved ethical or unethical – hired in a competitive labour market.
- OLG model – λ advisors enter and live for two periods.
- Regulator may identify bad advice $\rightarrow$ B, *a blemished record*.
- Three observable advisor histories:
  - New advisors, no history, wage $w_{\emptyset}$.
  - Senior unblemished advisor, wage w_{G}.
  - Senior blemished advisor, wage w_{B}

Model – Clients

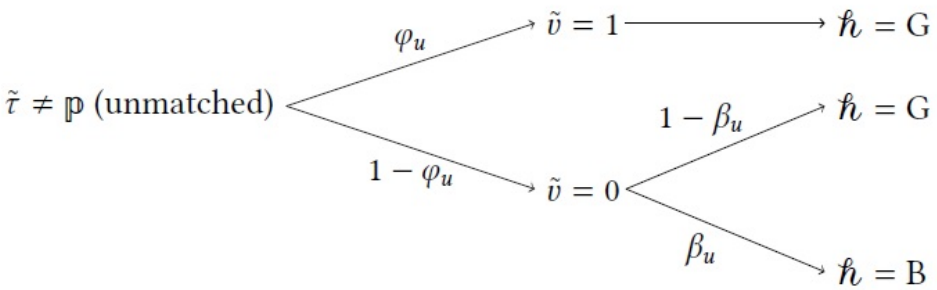
- Financial advisors choose products, (**s**) or (**t**) for client.
- **t** best for client w.p. q.
- Advisor sees what is best for client – client does not.

- Clients differ in wealth x and in probability of being sophisticated s: $f(x,s)$.
- Clients have positive $(\tilde{v}=1)$ or negative $(\tilde{v}=0)$ experience.

Advisor recommends product best for client



Advisor recommends against client interests



Advisor ethics

- Advisor receives bonus b when client invests in $\mathbf{t}$ – monetary, perks, future career benefits.
- Advisor may be ethical – with population prob θ
  - Ethical $\Rightarrow$ always advises right.
  - Unethical – draws random guilt cost c with CDF $G(c)$ each time.
    1. Humans sometimes lie when in their interests (Abeler et al. 2019).
    2. But can't be predicted and subject to reversals (Fischbacher and Follmi-Heusi (2013)).

  [Pure strategy here. Note on mixed strategies.]

- Allow for some unsophisticated clients – ignore advisor history and career concerns in inference.

Model Solution

Equilibrium Actions

- Search for equilibrium in which $w_\emptyset < w_G$ (Philippon and Reshef (2012), Oyer (2008)).

(1) Determine probability that unethical advisor, observing client type $\mathbf{s}$ nonetheless advises targeted $(\mathbf{t})$:

$$\begin{aligned} \text{Period 1:} \qquad & p_{\langle u|\mathbf{s}\rangle,2} = G(b), \\ \text{Period 2:} \qquad & p_{\langle u|\mathbf{s}\rangle,1} = G\left(b - (w_G - w_B)\Delta\tilde{\beta}\right) \end{aligned}$$

where $\Delta\tilde{\beta} = \beta_u(1-\varphi_u) - \beta_m(1-\varphi_m)$.

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(2) Determine probability advisor receives a blemish:

$$p_B = \tilde{\beta_m} + (1-\theta)(1-q)\Delta\tilde{\beta} \cdot p_{\langle u|\mathbf{s}\rangle,1}$$

(3) Apply Bayes' rule to update inference on advisor ethics: θ_G, θ_B.

$$\text{E.g. } \theta_G = \theta\frac{1-\tilde{\beta_m}}{1-p_B}$$

Equilibrium Market Characteristics

(4) Anticipated value created by financial advisor:

$$U_i(\tilde{\theta}) = \varphi_m - (\varphi_m - \varphi_u)(1 - \tilde{\theta})(1 - q)p_{\langle u|\mathbf{s}\rangle,i} \text{ for } i \in \{1, 2\}$$

(5) Market clearing and Bayes' rule can be used to prove that in equilibrium:

1. $U_2(\theta_B) < U_1(\theta) < U_2(\theta_G)$,
2. $w_B = \omega_{out} - bq$, and $w_B < w_\varnothing < w_G$.

Full model

Smart Money

Define *smart money* as $x \cdot s$:

- wealth times probability of sophistication.
- Distribution $H(\cdot)$.

Allows equilibrium to be characterised.

Proposition: equilibrium characterisation

Suppose wage order is such that new financiers earn less than senior unblemished ones. Clients subdivide by level of smart money ($\rho := x \cdot s$):

1. firms serving clients with $\rho \in [0, \rho_\varnothing)$ employ blemished advisors ($\mathcal{H} = \mathrm{B}$);
2. clients with $\rho \in [\rho_\varnothing, \rho_\mathrm{G})$ get new advisors (history $\mathcal{H} = \varnothing$);
3. clients with smart money $\rho \in [\rho_\mathrm{G}, \infty)$ employ senior unblemished advisors ($\mathcal{H} = \mathrm{G}$).

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Proposition: uniqueness & existence

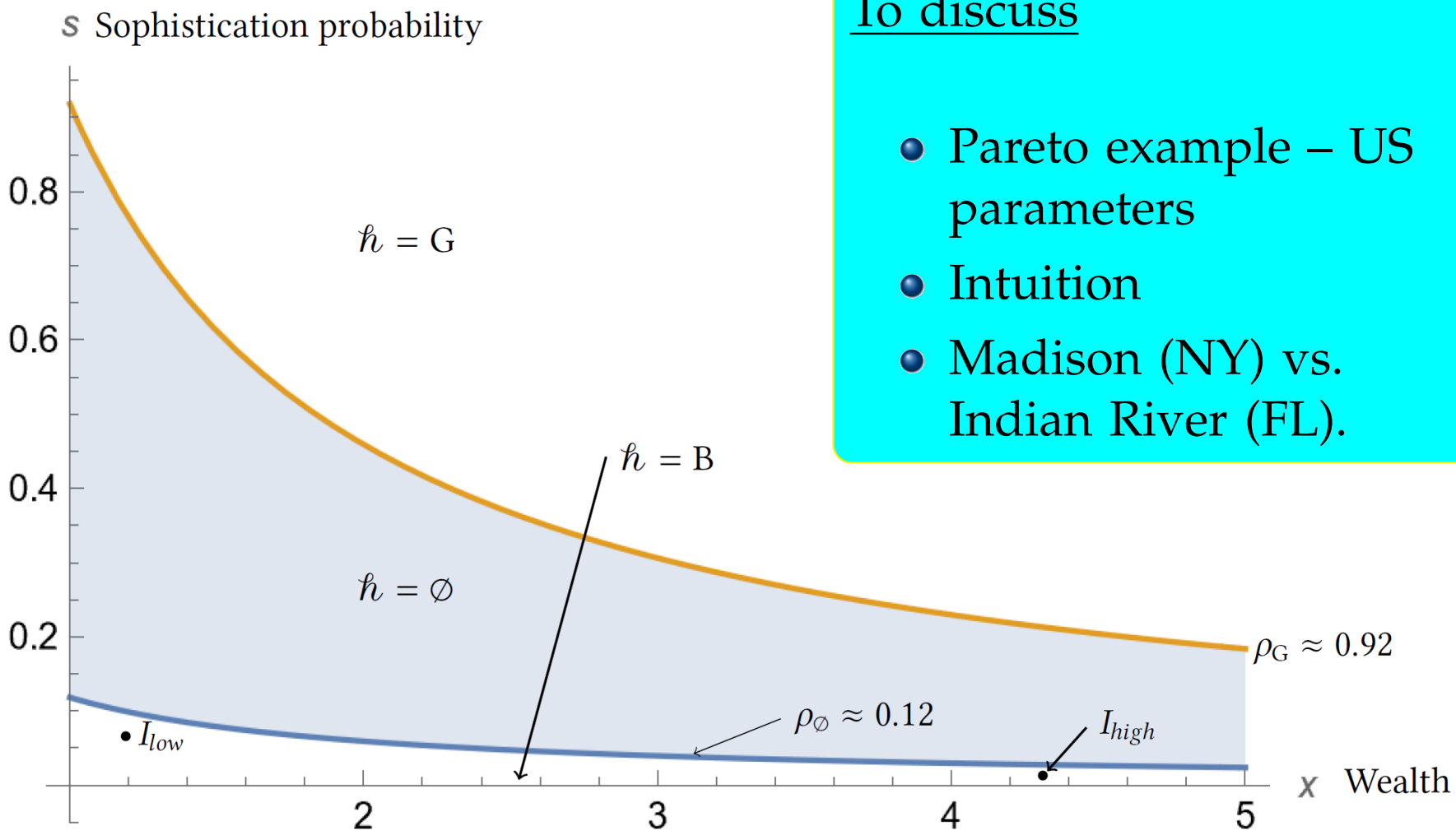
- The wage of senior unblemished advisors satisfies:

$$w_\mathrm{G} = (\rho_\mathrm{G} - \rho_\varnothing)\,(U_2(\theta_\mathrm{G}) - U_1(\theta)) + \rho_\varnothing\,(U_2(\theta_\mathrm{G}) - U_2(\theta_\mathrm{B})) + \omega_{out} - bq$$

$$\rho_\mathrm{G} = H^{-1}\left(1 - \lambda(1 - p_\mathrm{B})\right) \qquad \text{and} \qquad \rho_\varnothing = H^{-1}\left(1 - \lambda(2 - p_\mathrm{B})\right)$$

- Uniqueness follows if smart money weakly concave: $H''(\rho) \leq 0$.

Graphical Representation



To discuss

- Pareto example – US parameters
- Intuition
- Madison (NY) vs. Indian River (FL).

Increasing Wealth of the Richest

The Rich get Richer

- Share of national income for wealthiest 10% of Americans risen from 35% (in 1980) to $\approx$ 50% (in 2018), (Alvaredo et al. (2018)).
- Increasing lack of trust in financial professionals (Sapienza and Zingales (2012)), who might even lie more than general population (Cohn, Fehr, and Marechal (2014)).

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- We study wealth distribution changing through First-Order Stochastic Dominance:

$$H^{ineq}(\rho) < H(\rho).$$

Captures:

1. Wealth of all rising and/or
2. Richest getting richer fastest.

Inequality, Trust and Pay

Proposition

Suppose distribution of smart money changes to $H^{ineq}(\rho)$ which FOSD $H(\rho)$ (*smart money dist. pushed up / rich getting richer*):

1. Clients trust good financial advisors (i.e. with no blemish) less:

$$\theta_{\mathrm{G}}^{ineq} < \theta_{\mathrm{G}}.$$

2. Whilst the wage of good financial advisers rises:

$$w_{\mathrm{G}}^{ineq} > w_{\mathrm{G}}.$$

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Intuition:

- More wealth $\Rightarrow$ clients move out of B region into $\{\emptyset, \mathrm{G}\}$.
- Can't re-equilibrate without $w_{\mathrm{G}} \uparrow$.
- Career concerns cause advisors to disguise early on.
- So clients trust good (unblemished) advisors **less**.

Industry Discipline

- Approx 25% of financial advisors leave the industry after a misconduct record – the rest remain (Egan et al. 2019).
- Does industry discipline improve with increased wealth inequality?

Corollary

Suppose that the distribution of smart money moves up (e.g. rich getting richer). The probability of being forced to exit the industry after misconduct increases.

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Intuition:

- Higher wages lower the probability of cheating in early career.
- Increases the volume of unblemished senior advisors.
- The volume of blemished advisors $\downarrow$ whilst measure out constant $(2\lambda - 1)$, so proportion out $\uparrow$.

Wealth Distribution and Misconduct

- How does the proportion of deliberately wrong investment decisions change as society gets richer?
- Magnitude of wrongdoing differs across the three histories $(B, \emptyset, G)$.

Proposition

Suppose that $\lambda = \frac{1}{2}$ new advisors are born every period.
Suppose that the distribution of smart money changes to reflect FOSD.
The proportion of financial advisor decisions which are fraudulent declines.

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Intuition:

- Average ethics across B and G populations known: θ.
- Assumptions imply none of B exit.
- Career concerns only remaining effect.

Conclusions

Conclusions so far

- Model financial advisors' pay, trustworthiness, and ethical behaviour in an OLG competitive model with career concerns.
- Clients with low sophistication or wealth forced to use blemished advisors.
- Rich getting richer or wealth of all rising results in public trusting financial advisors less, whilst pay of financial advisors is driven up.
- Such a change in wealth distribution improves industry discipline by forcing greater proportion of blemished advisors out.
- And it lowers the aggregate amount of misconduct the industry perpetrates.
  - Measured as the proportion of investment decisions which are deliberately wrong.

Further Results

- Two point wealth distribution worked example.
  - Separately study levelling up, increasing top end inequality, and SOSD.
- Better regulation by reducing type II errors ($\beta_u \uparrow$).
- Corporate Governance: incentives to monitor given client wealth.
- Corporate Governance: penalties for misconduct and implications for pay and trust.

Simplest version – to fix ideas

Simplifying Assumptions

Suppose

- All clients have same wealth, x, and are sophisticated.
  - $\Rightarrow$ firms indifferent between all advisors:

$$xU_2(\theta_G) - w_G = xU_1(\theta) - w_\emptyset = xU_2(\theta_B) - w_B$$

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Then

$$w_G = x \cdot (\varphi_m - \varphi_u)(1-q)G(b)\theta \frac{1}{1 - G(b - w_G\tilde{\beta}_u)}$$

and solution solves model.

Trust and Pay

$$w_G = x \cdot (\varphi_m - \varphi_u)(1-q)G(b)\,\theta \underbrace{\frac{1}{1 - G(b - w_G\tilde{\beta}_u)}}_{\theta_G}$$

- Equilibrium w_G is unique.
- Pay w_G is increasing in population wealth, x.
- But then trust θ_G declines in population wealth (x).

These results are general...