



To trust is good, but to control is better: How investors discipline financial advisors' activity[☆]



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ARTICLE INFO

Article history:

Received 26 January 2017

Received in revised form 13 April 2017

Accepted 16 April 2017

Available online 3 June 2017

JEL classification:

G11

G24

D80

Keywords:

Financial advice

Financial literacy

Credence services

ABSTRACT

Using a survey of clients from one of the largest Italian banks, we find that investors with low level of trust in professional advisors seek financial counselling, but make their decisions autonomously. We investigate whether these investors exert some form of control over the recommendations they receive, and, if so, which one. Investors can push advisors to provide better recommendations either by asking for a second expert's opinion, such as in the case of credence services, or by monitoring closely the advisor's activity themselves. We find that three quarters of investors do not exert any control on advisors. Different types of financial competence – *self-assessed* or *test-based* – serve different purposes. The investors featuring higher *self-assessed* financial competence are more likely to control the advisor's activity. The mechanism through which investors exert control over the advisors' activity depends instead on the investors' degree of *test-based* financial literacy. Investors with high financial literacy directly monitor the advisors' activity. Investors with low financial literacy are more likely to seek a second professional opinion in support of the recommendations previously received. Our findings suggest that improving investors financial knowledge may foster direct control of the advisor's activity. Moreover, facilitating the comparison between financial products by standardized and centralized information may be very effective to protect poorly literate investors.

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1. Introduction

Investors are being confronted with increasingly complex financial decisions, partly because shifting economic policies have forced them to take on more responsibilities and partly because the menu of retail financial products has been growing steadily. This poses a serious challenge to investors who want to buy the best possible financial product, given their lifetime needs. Several authors (Georgarakos and Inderst, 2011; Inderst and Ottaviani, 2012a,c) argue that the optimal financial choice depends on investor-specific need and personal characteristics. For example, the best real estate mortgage, the

[☆] We thank Annamaria Lusardi, Olivia Mitchell, Chiara Monticone, and seminar participants at the Cherry Blossom Financial Education Spring Institute 2015 (George Washington School of Business), SKEMA Business School (Lille), the EEA Annual Conference 2016 (Geneva), the FMA Annual Conference 2016 (Las Vegas) and the 1st Conference on Behavioral Economics and Financial Literacy (Barcelona) for helpful comments and discussions. Moreover, we also thank Laura Marzorati at Pioneer Investments for providing access to the Unicredit Customers Survey. We kindly acknowledge financial support from the European Commission through the Seventh Framework Programme for the project 'Mobilising the Potential of Active Ageing in Europe'.

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optimal pension scheme or long-term saving plan depend, respectively, on the client's expected income stream, desired level of well-being at retirement, risk attitude or tax bracket. To identify the optimal financial product, investors can rely on the advice of experts. Gennaioli et al., 2015 consider professional financial advice as a *credence service* similar to medicine, where “money doctors help investors to get the most appropriate treatment”.¹ Like for medical treatments, the accuracy of the expert in solving the client problem is not observable, the final success of the service is not contractible, and the expert's effort is costly, so that the investor–advisor relation is affected by moral hazard (Pesendorfer and Wolinsky, 2003; Fong, 2005; Dulleck and Kerchmbamer, 2006). Investors who rely on professional financial advice either do so because they trust their advisors (Gennaioli et al., 2015), or because they are not aware of advisors' moral hazard (as the *naive* investors in Inderst and Ottaviani, 2009, 2012c), or because, despite anticipating a conflict of interest with the advisor, they think they are able to control effectively the quality of the recommendations they receive.

This paper studies whether investors exert some form of control over the recommendations they receive from professional advisors. More precisely, we check whether investors push advisors to give them better advice either by searching for a second professional opinion (as postulated by Pesendorfer and Wolinsky, 2003) or by monitoring the advisor's activity themselves. When the advisor expects the investors–advisees to seek a second opinion, he has stronger incentives to provide sounder recommendations. Alternatively, as in any principal–agent relation with a conflict of interests, advisors are pushed to exert more effort if the advisees closely monitor their activity. We also investigate how the investors' degree of financial knowledge, measured both in subjective and in objective terms, affects the control mechanism they enact. Our main hypothesis is that while highly financially knowledgeable investors can control the advisor's activity by themselves, through direct monitoring, the least financially literate ones may search for a second opinion.

Identifying the mechanism of control used by investors to incentivize advisors to provide better recommendations, if any, is important in order to design an effective consumer financial protection regulation (Campbell et al., 2011). For example, if more knowledgeable investors verify professional advice on their own, then clear and transparent disclosure of fees, returns and other characteristics of the recommended financial product simplify their tasks. Disclosure and transparency are sufficient for highly literate investors, but not for low literate ones: they need standardization of products to be able to compare different recommendations.

We test our predictions using the 2007 Unicredit Investors Survey (UCS) conducted on a sample of 1676 individuals with a current account in one of the banks of the largest Italian banking group.

The survey contains information on the way individuals manage their financial investments, that is, whether they invest autonomously (“Self”), ask for advisor counselling but decide independently (“Advice”), or fully delegate their choice to a professional advisor (“Delegation”). According to Gennaioli et al., 2015, professionals guide investors with little knowledge in the acquisition of risky assets and investors delegate their risky investments to the advisor they trust the most. When considering the subsample of investors holding risky assets, we show that only 20% of investors delegate their investments, while 69% of investors consult advisors but then make their decisions autonomously. If we consider the subsample of investors holding risky assets and relying on some form of professional counselling, we find that 74% of them do not exert any form of control on advisor's activity, which suggests either a widespread investors inertia (Bhattacharya et al., 2012) or a large presence of naive investors (Inderst and Ottaviani, 2012c).

When it comes to explain which investor's characteristics affect the control behavior, we find that *self-assessed* financial literacy and *test-based* financial literacy play two important distinct roles.

The degree of *self-assessed* financial literacy is strongly related to the probability of exerting some control activity: Investors who are more confident in their own financial knowledge are more likely to check the advisors' activity. As suggested by Allgood and Walstad, 2016, the self-assessed degree of knowledge reflects a person's self-image and is then natural to observe that self-confident investors rely on their own judgement to control the advisor's behavior.

The degree of *test-based* financial literacy, instead, impacts the disciplining mechanism put in place. Investors with the highest level of test-based financial literacy exert a direct form of control on advisors' activity. Instead, investors with the lowest level of financial literacy are more likely to compare the recommendations they receive with second opinions, as postulated by Pesendorfer and Wolinsky, 2003 for standard credence services. These results are robust if we take into account the potential endogeneity of both the level of trust in advisors and the degree of financial literacy.

Our findings are consistent with some related results in the literature. For example, Bhattacharya et al., 2012 report that investors with low trust in the advisors and a low level of financial sophistication are less likely to demand professional advice, even when this is certified as unbiased. According to the credence service view adopted in our paper, investors with low trust in advisors probably do not believe they are being offered unbiased recommendations. Investors with low trust and low financial literacy may want to verify the recommendations by asking to a second expert, which may not have been possible in the setting described by Bhattacharya et al., 2012. That could be a reason why they did not demand advice in the first place.

Stolper and Walter, 2015 consider the case of neutral financial advice generated by a computer algorithm, which has been certified to be free from conflicts of interest and efficient.² They report that more financially knowledgeable households

¹ Gennaioli et al., 2015.

² The financial advice studied in Stolper and Walter, 2015 consists of a unique “set of product-level recommendations covering retirement provision as well as the insurance of risks relating to income, property, and health of all household members” (Stolper and Walter, 2015, p. 5).

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