DOL's Retirement Advice Rule: Helping or Harming Sound Retirement Planning?

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Executive Summary

Since the Department of Labor (DOL) originally proposed its fiduciary rule in 2010, one of the focal points in the debate over retirement accounts has been the relationship between financial advisers and their clients, especially in relation to IRAs. Many individuals turn to professional advisers due to the difficulty of handling complicated financial decisions or just to save time. However, certain commission compensation structures, are seen as a conflict of interest by some policymakers and are often blamed for poor investment returns. These worries are the main reason for the Department of Labor's proposed "fiduciary" rule definition, which aims to modify the rules financial advisers must follow when working with tax-qualified retirement savings plans, including IRA accounts. However, the release of the proposed rule has raised many questions about the far-reaching consequences and potential negative impacts on the one thing that the rule hopes to accomplish: increasing savings and providing a secure retirement for individuals.

Current U.S. retirement markets are characterized by an aging population with longer life expectancy, a Social Security system under financial stress, the shift of employer-sponsored plans from Defined Benefit to Defined Contribution plans, and shorter job tenures. All these trends point to the importance of saving for retirement and keeping these funds intact during working years. Whether it is due to behavioral reasons (i.e. lack of self-control or discipline, the culture of instant gratification that fuels over-consumption, and overconfidence about one's own judgment and abilities) or lack of financial knowledge, U.S. retirement savings is less than optimal. However, research shows that people who work with financial advisers do better than their counterparts who do not have access to financial advice.

Earlier this year, the White House Council of Economic Advisers (CEA) lent its support to the DOL fiduciary rule by summarizing some academic literature on the cost of conflicted advice on retirement savings, especially for IRA account holders. CEA claimed that investment underperformance amounts to a cost of $17 billion per year. DOL's Regulatory Impact Analysis followed a similar approach and assumes that the rule will eliminate the underperformance difference resulting in a benefit to investors of $4 billion per year. Both reports have been criticized by economists based on their use of simplified assumptions, stale data, and generalizations to reach their conclusions. The most significant critique of both reports is that the analysis ignores the benefits associated with financial advice. These benefits include increased savings rates, less risky and speculative trading, age and goal appropriate portfolio balancing. According to research, including prior analysis issued by the DOL, the value of financial advisers could be more than the cost of conflicted advice envisioned by both the CEA and DOL.

Other widely cited potential consequences of the re-proposed rule include:

- Cost increases and decreased access to financial advice especially for low and moderate income individuals
- Increased leakage of assets during job changes
- Decreased access to workplace retirement for small businesses
- Limits to investment education

When these potential consequences are quantified, one analysis shows that the re-proposed rule could decrease retirement savings between $68 and $80 billion each year.

A comprehensive retirement policy designed to maintain growth in savings, expand coverage, and prevent leakage during job changes is imperative for retirement security. The recently re-proposed DOL fiduciary rule, meant to protect the retirement savings of individuals, may well have the opposite effect. The DOL rule should be more fully analyzed and adjustments made to ensure the rule does not have an adverse impact on retirement plan access and investment education.

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Introduction

Since the Department of Labor (DOL) originally proposed its fiduciary rule in 2010, one of the focal points in the debate over retirement accounts has been the relationship between financial advisers and their clients, especially in relation to IRAs. Many individuals turn to professional advisers due to the difficulty of handling complicated financial decisions or just to save time. However, current compensation structures, including commissions for financial advisers, are seen as a conflict of interest by some policymakers and are often blamed for poor investment returns. These worries are the main reason for the Department of Labor's proposed "fiduciary" rule definition, which aims to modify the rules financial advisers must follow when working with tax-qualified retirement savings plans, including IRA accounts. However, the release of the proposed rule has raised many questions about the far-reaching consequences and potential negative impacts on the one thing that the rule hopes to accomplish: increasing savings and providing a secure retirement for individuals.

This report first investigates changes in U.S. retirement markets and saving trends with a detailed look at the issues impacting the savings behavior of households. It then discusses the possible impact of the proposed rule on these trends.

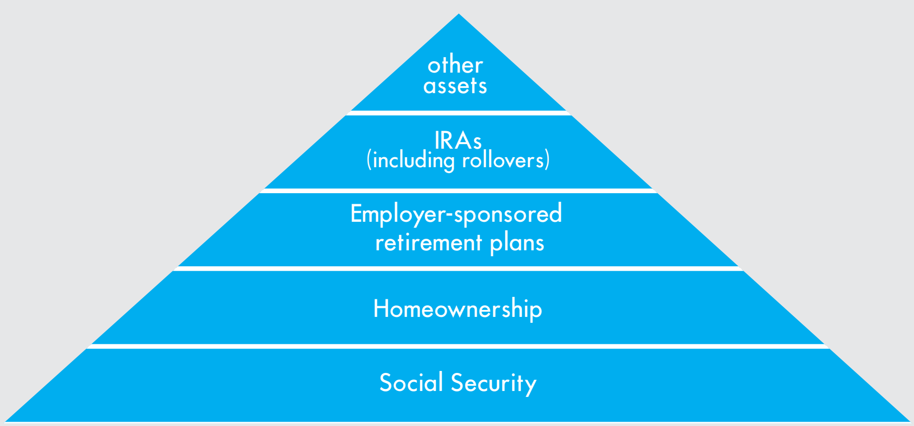
U.S. Retirement Markets

Social Security System on Shaky Ground and An Aging Population

In the U.S., retirees rely on multiple sources of income as represented by the five-layered pyramid in Figure 1. While the share of each source has changed over the years, Social Security still plays a key role in retirement security for the majority of retirees. For many, Social Security income is supplemented by homeownership, employer-sponsored retirement plans, IRAs, and other assets.

However, questions about the financial health of the Social Security system and the continuing retirement of the baby boomers have increased the importance of the other income sources in this pyramid. According to the 2015 Social Security Trustees Report, it is expected that Social Security will be able the pay full benefits until 2034. After 2034, the income generated by payroll taxes and other sources will only be sufficient to pay 79 percent of scheduled benefits.[1]

Figure 1. Retirement Resource Pyramid



Source: 2015 Investment Company Fact Book, A Review of Trends and Activities in the U.S. Investment Company Industry, Investment Company Institute, www.icifactbook.org

1 "The 2015 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds," http://www.ssa.gov/oact/tr/2015/tr2015.pdf

Directly related to the expected shortfall in Social Security funding are U.S. demographic trends that will not only strain other public expenditures, such as Medicare, but will also have an impact on families, businesses, and health care providers. According to a recent analysis by the Census Bureau, by 2030, more than 20 percent of U.S. residents will be 65 and over, compared to 13 percent in 2010 and 9.8 percent in 1970.[2] There has also been an increase in life expectancies due to public health campaigns (e.g., against smoking) and medical advances. According to 2012 National Projections, a non-Hispanic white and Asian or Pacific Islander male is expected to live an additional 18.1 years at age 65 in year 2012 (20.7 for a female). For the year 2050, a male with the same racial profile who turns 65 will be expected to live 20.6 more years (23.5 for a female).[3]

Given the fact that people are living longer and are expected to spend a longer time in their retirement years and that the very safety net that many people see as their sole source of income is on shaky grounds, policymakers are looking for ways to encourage personal savings during working years to provide for a secure retirement.

Replacement of Defined Benefit with Defined Contribution Plans

Before the 1980s, most employer-sponsored retirement plans were Defined Benefit or "DB" plans, under which an employer promises a specified monthly benefit during retirement based on certain criteria such as the employee's length of tenure and earnings history. Beginning in the 1980s, the structure of employer-sponsored plans began to shift from DB plans, towards Defined Contribution or "DC" plans. Under DC plans, the employee or the employer (or both) contribute to the employee's individual account and the employee can collect the accumulated contributions plus investment returns at retirement. The major reasons behind this shift were flexibility and costs for both employees and employers. For employers, DC plans are more attractive since they avoid the long-term funding and liability commitments that come with DB plans. They are also less costly. In fact, a recent analysis by the U.S. Bureau of Labor Statistics (BLS) shows that in March 2012, private industry worker participation costs were more than 70 percent higher for DB than for DC retirement plans.[4] Also, the control over retirement accounts as well as portability of these accounts, especially for individuals with short job tenures, make DC plans more attractive for employees, but also brings more personal responsibility in the investment management of these accounts.

Short Job Tenures

Even though it has increased slightly, the length of job tenure among the U.S. workers 16 years and over has hovered around 4+ years since January 2004. According to the most recent BLS data, the median number of years that wage and salary workers had been with their current employer was 4.6 years in January 2014.[5] However, an increasing number of millennials (those roughly 18 to 34 years old) have different job expectations and attitudes, as well as shorter tenure than the average worker.[6] For example, for those aged 25 to 34, the median number of years with their current employer was three. This could mean as many as 15 different jobs for this generation over their working life. Many millennials see frequent job changes as a tool for career development. However, continuous circulation between jobs also has implications for their retirement years and requires a comprehensive, flexible retirement system to keep their savings intact during their working lives.

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2 Jennifer M. Ortman, Victoria A. Velkoff and Howard Hogan, "An Aging Nation: The Older Population in the United States," May 2014, U.S. Census Bureau, https://www.census.gov/prod/2014pubs/p25-1140.pdf

3 Ibid, pg 4.

4 "Retirement Costs for Defined Benefit Plans Higher than for Defined Contribution Plans," Bureau of Labor Statistics, December 2012. http://www.bls.gov/opub/btn/volume-1/pdf/retirement-costs-for-defined-benefit-plans-higher-than-for-defined-contribution-plans.pdf

5 "Employee Tenure in 2014," Bureau of Labor Statistics, September 18, 2014. http://www.bls.gov/news.release/pdf/tenure.pdf

6 The millennials' attitude and expectation towards employment have been a topic of interest by various groups. See http://www.wsj.com/articles/how-employers-wrangle-restless-millennials-1430818203, http://www.forbes.com/sites/jeannemeister/2012/08/14/job-hopping-is-the-new-normal-for-millennials-three-ways-to-prevent-a-human-resource-nightmare/ as well as http://www.publichealth.indiana.edu/docs/departments/RPTS/Understanding%20Millennials%20in%20the%20Workforce.pdf

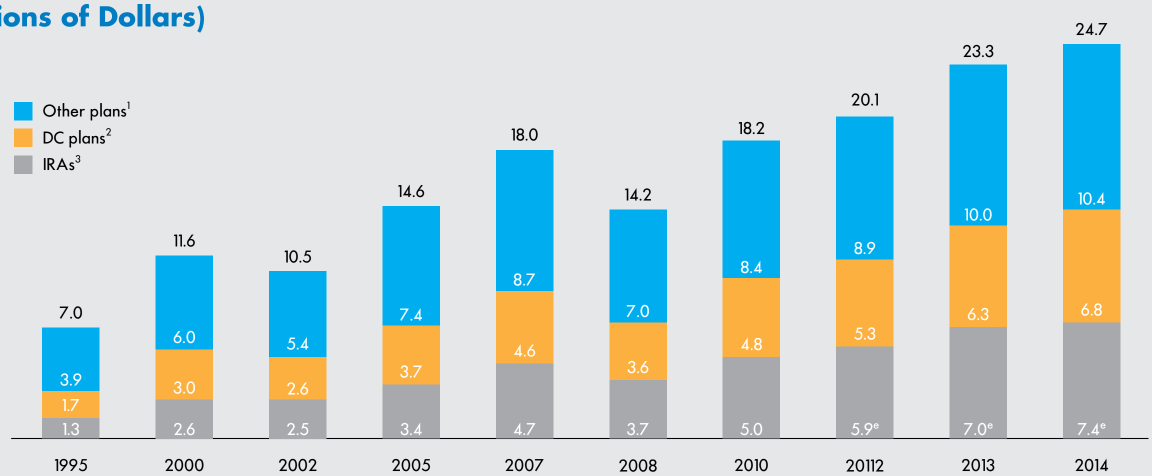
Retirement Savings: A Closer Look

The accumulated retirement savings across employer-sponsored and government retirement plans (both DB and DC plans), IRAs, and annuities totaled $24.7 trillion at the end of 2014. Figure 2 represents the division of these assets between major plan types. IRAs and DC plans represent the largest share; $7.4 and $6.8 trillion, respectively. In Figure 2, other assets consist of private sector DB plans ($3.2 trillion), state and local government DB plans ($3.8 trillion), federal government DB plans ($1.4 trillion), and annuity reserves outside of retirement plans ($2 trillion). The growth of these assets from $7 trillion in 1995 to $24.7 trillion in 2014 shows that U.S. households with access to such plans continue to participate and that these plans represent an important source of private investment capital for the U.S. economy.

IRAs play a key role in retirement security. First created in 1974, this retirement vehicle not only provides a tax incentive for savings but also provides a mechanism to preserve the assets accumulated under employer-sponsored retirement plans for workers changing jobs through rollover opportunities. New types of IRAs were introduced later to encourage small employers to start retirement plans by simplifying the rules applicable to tax-qualified plans. Given that 99 percent of U.S. employers are small businesses; these vehicles have even greater importance for reaching a large share of the U.S. workforce.

Nearly 42 million U.S. households owned at least one type of IRA as of mid-2014. However, IRA growth has been fueled by investment returns and rollovers from employer-sponsored retirement plans, rather than new contributions. For example, in 2012, only 10 percent of new traditional IRAs were opened with new contributions, and 87 percent were started with rollovers.[7]

Figure 2. U.S. Retirement Assets, Selected Years
(Trillions of Dollars)



[1] Other plans include private-sector DB plans; federal, state, and local DB plans; and all fixed and variable annuity reserves at life insurance companies less annuities held by IRAs, 403(b) plans, 457 plans, and private pension funds. Federal pension plans include U.S. Treasury security holdings of the civil service retirement and disability fund, the military retirement fund, the judicial retirement funds, the Railroad Retirement Board, and the foreign service retirement and disability fund. These plans also include securities held in the National Railroad Retirement Investment Trust.
[2] DC plans include 401(k) plans, 403(b) plans, 457 plans, the Federal Employees Retirement System (FERS) Thrift Savings Plan (TSP), Keoghs, and other private-sector DC plans without 401(k) features.
[3] IRAs include traditional IRAs, Roth IRAs, and employer-sponsored IRAs (SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs).
[e] Data are estimated.

Source: 2015 Investment Company Fact Book, A Review of Trends and Activities in the U.S. Investment Company Industry, Investment Company Institute, www.icifactbook.org

7 2015 Investment Company Fact Book, A Review of Trends and Activities in the U.S. Investment Company Industry, Investment Company Institute, pg 153, www.icifactbook.org,

Access to Employer-Provided Retirement Benefits and Retirement Savings Plans

Despite the strong growth in savings earmarked for retirement, there is still room for improvement in U.S. retirement markets. According to a recent report by the Center for American Progress, nearly one-third of working Americans do not have any retirement savings or a pension.[8] Given that employer-sponsored retirement plans remain the most important vehicle for retirement saving for many working-age households, access to such plans carries greater importance. According to the most recent National Compensation Survey (NCS) conducted by BLS, retirement benefits (both DC and DB plans) were available to 66 percent of private industry workers in the U.S. (See **Table 1**) However, there are disparities by firm size, as well as by wage levels. For example, among the lowest wage quartile, access to employer-sponsored retirement plans was 40 percent in the private sector. For the lowest 10 percent of wage earners, access was even lower: 31 percent. These numbers indicate that, especially among low-income households, lack of access to employer-sponsored retirement plans remains an important problem. Access can be an important tool for encouraging workers who are at the beginning of their careers to create a habit of saving for retirement.

Table 1. Retirement Benefits[1]: Access, Participation and Take-up[2] Rates, March 2015 (percentage)

	Civilian[3]			Private Industry			State and Local Government		
	Access	Participation	Take-up rate	Access	Participation	Take-up rate	Access	Participation	Take-up rate
All Workers	69	53	77	66	49	74	90	81	90
	By wage								
Lowest 25 percent	42	22	52	40	19	48	75	67	90
Lowest 10 percent	31	12	40	31	12	39	61	54	89
Second 25 percent	71	53	75	67	47	70	93	83	89
Third 25 percent	81	68	83	78	63	81	94	84	89
Highest 25 percent	89	79	88	86	75	88	98	89	91
Highest 10 percent	90	80	90	88	78	89	98	89	91
	By Establishment Size								
1 to 99 workers	52	36	70	51	35	69	78	70	89
1 to 49 workers	46	33	71	46	32	70	70	63	90
50 to 99 workers	67	46	69	66	44	67	91	80	89
100 workers or more	86	69	81	84	65	78	91	82	90
100 to 499 workers	81	61	75	80	58	72	88	80	91
500 workers or more	91	79	87	89	76	85	93	83	89

1. Includes DB and DC retirement plans.
2. The take-up rate is an estimate of the percentage of the workers with access to a plan who participate in the plan.
3. Includes workers in the private nonfarm economy except those in private households, and workers in the public sector, except the federal government.

Source: "Employee Benefits in the United States – March 2015," July 24, 2015. Bureau of Labor Statistics, U.S. Department of Labor, http://www.bls.gov/news.release/pdf/ebs2.pdf

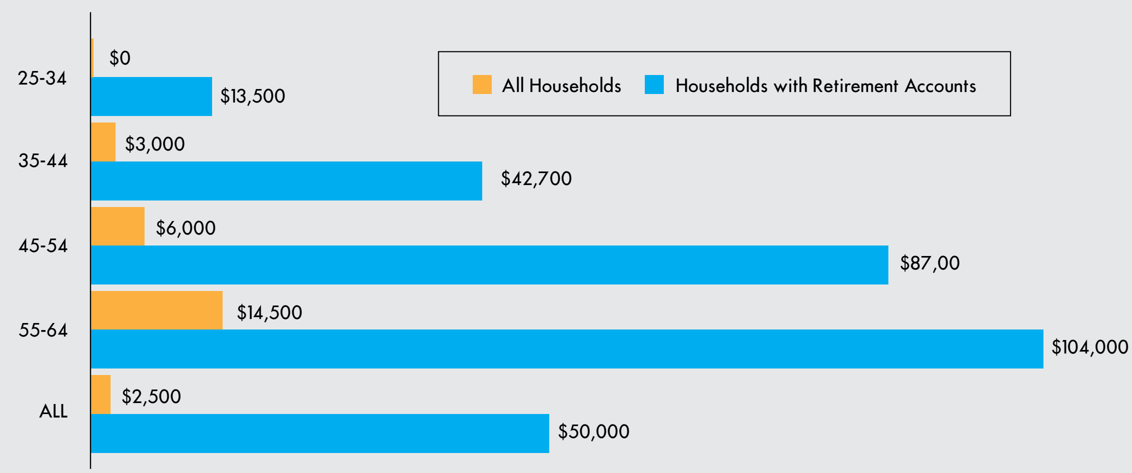
8 Keith Miller, David Madland and Christian E. Weller, "The Reality of Retirement Crisis," January 2015, Center for American Progress, https://www.americanprogress.org/issues/economy/report/2015/01/26/105394/the-reality-of-the-retirement-crisis/

When the same data is analyzed based on establishment size, it is apparent that private sector workers at small businesses also suffer from a lack of access to employer-sponsored retirement plans. For individuals working for establishments with less than 50 workers, only 46 percent had access to retirement benefits. As the size of the establishment increases, access also increases. For example, 89 percent of workers at an establishment with more than 500 workers had access to these benefits. This trend is not surprising. Small establishments find it costly or burdensome to start their own retirement plans. Not having "enough employees to make it worthwhile" or uncertainty about the future of the business are other reasons for not offering retirement benefits.[9]

Furthermore, having access to retirement benefits does not guarantee participation in these plans. Among the lowest 10 percent of wage earners, only 12 percent actually contribute to a retirement plan. As the wage level rises, so does participation. According to Table 1, the highest 10 percent of wage earners had a 78 percent participation rate. Increased participation may be a result of companies providing matching contributions as a recruitment tool attracting high-wage workers with additional incentives.

According to the most recent Survey of Consumer Finances (2013), a typical working-age household with a retirement account (DC or IRA) has $50,000 in retirement assets (See Figure 3).[10] For the households closer to retirement, age 55-64, households with retirement accounts have a median account balance of $104,000 versus $14,500 for all households. The numbers indicate stark differences in retirement assets among households that use retirement accounts and those that do not. It shows that there still is much to do to encourage all working-age households to save adequately for their retirement needs.

Figure 3. Retirement Account Assets: Median Household Retirement Account Balances by Age and Household Type



Source: Keith Miller, David Madland and Christian E. Weller, "The Reality of Retirement Crisis," January 2015, Center for American Progress, https://www.americanprogress.org/issues/economy/report/2015/01/26/105394/the-reality-of-the-retirement-crisis/

9 Based on a recent Wakefield Research and Capital One ShareBuilder 401(k) online survey of 500 business owners at companies with 50 or fewer employees. http://www.wakefieldresearch.com/blog/2013/08/12/why-small-businesses-dont-offer-retirement-plans

10 Keith Miller, David Madland and Christian E. Weller, "The Reality of Retirement Crisis," January 2015, Center for American Progress, https://www.americanprogress.org/issues/economy/report/2015/01/26/105394/the-reality-of-the-retirement-crisis/

Why is Retirement Savings Lacking?

Behavioral Aspects

To support themselves in their retirement years, Americans need to save more aggressively. But retirement planning is a complex task and as modern behavioral economics points out, when faced by complex problems and uncertainty, people use heuristics or rules of thumbs that often result in less than optimal outcomes. Such behavior is sometimes classified as irrational.[11] There may be a number of reasons for irrational behavior. Some individuals lack the self-control or discipline to implement a savings plan. The current structure of DC plans with automatic enrollments, automatic contributions, and auto-escalation options have been successful in helping overcome this issue. But for people without access to a plan, self-control remains a problem.

Time preference is also a major issue for Americans. Individuals prefer smaller amounts now over larger amounts in the future. The culture of instant gratification fuels the over-consumption habits of Americans. The current environment of low-interest rates also contributes to the trend. Also, a recent study shows that lack of imagination and inability to identify with one's future self can cause individuals to allocate fewer funds for future consumption.[12] The authors of the study detail an experiment in which individuals were allowed to interact with age-progressed renderings of themselves, and when they did so, such individuals chose to save more.

Overconfidence, whether related to a person's own judgment and abilities or about the future of the American economy, may also result in less than optimal savings. Believing that one can beat the market or that improvements in the economy will bring higher returns may lead individuals to believe that they have enough savings for a comfortable retirement. This kind of belief can also take the pressure or urgency off the need to make necessary investments for one's future.

Lack of Financial Knowledge

One important issue for American savers has been the link between the lack of financial knowledge and retirement readiness. Various studies show that many Americans lack a basic understanding of key financial concepts, such as how compound interest works, the impact of inflation, and diversification of risk. Professors Annamaria Lusardi and Olivia Mitchell asked a group of individuals aged 50 and older three questions[13]:

1. What would the balance be after five years, given an initial deposit of $100 and an interest rate of 2 percent,
2. What is the impact of inflation on the purchasing power of savings, and
3. Whether holding stock in a single company or investing in a stock mutual fund provides a safer return.

When tabulated, the results of the survey showed that only one-third of respondents could correctly answer all three questions. According to the authors of the study, even though the group of individuals lived through periods of high inflation, as well as multiple stock market crashes, they still lacked a basic understanding of investment risk.

The financial knowledge issue is not only a problem for older Americans, but impacts all age groups. Most high school students and college students also receive failing grades for financial literacy.

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11 For an in-depth discussion, Pinar Cebi Wilber, "Making Savings Last During Retirement: Lessons from Behavioral Economics," August 2007, American Council for Capital Formation, http://accf.org/wp-content/uploads/2012/03/makeSavingsLast.pdf

12 Hal E. Hershfield, Daniel G. Goldstein, William F. Sharpe, Jesse Fox, Leo Yeykelis, Laura L. Carstensen, and Jeremy N. Bailenson, "Increasing Saving Behavior Through Age-Progressed Renderings of the Future Self," Journal of Marketing Research, 2011, http://www.russellsage.org/sites/all/files/u137/jmr-D-s023-s037-online.pdf

13 AnnaMaria Lusardi and Olivia S. Mitchell, "The Economic Importance of Financial Literacy: Theory and Evidence," Journal of Economic Literature, 2014, 52(1): 5-44. Pg 10

Some studies have looked at the gap in financial knowledge between the genders, as well as between different races. Regardless of education levels, females have lower financial knowledge than their male counterparts. For example, according to a study conducted by Mahdavi and Horton, the alumnae of highly selective liberal arts colleges for women still had very low financial literacy.[14] The same gap is also apparent among certain demographic groups, such as African-Americans and Hispanics. According to a TIAA-CREF Institute study, even among college educated Hispanics, 32 percent have basic financial literacy, and only 12 percent have high financial literacy.[15] In another study, using the National Financial Capability Study, Prof. Lusardi and Prof. Mitchell demonstrate that Hispanics and African-Americans score the lowest on financial literacy concepts.[16]

Lack of financial knowledge is a very important issue because it directly translates into inadequate retirement planning and low savings. In fact, the DOL provided estimates of the financial mistakes of participants associated with flawed information or reasoning in its analysis of the 2011 final rule implementing the investment advice provision of the Pension Protection Act.[17] According to the analysis, financial losses from investment mistakes amounted to more than $114 billion in 2010. The Department acknowledged that some of the loss could be attributed to lack of expert financial advice.

DOL Fiduciary Rule and U.S. Retirement Markets

What is the DOL Fiduciary Rule?

First proposed on October 22, 2010, then re-proposed on April 20, 2015, the DOL fiduciary rule aims to modify and expand the definition of "fiduciary" that has been in place since 1975 – shortly after the enactment of the Employee Retirement Income Security Act of 1974 (ERISA). In a nutshell, the proposed rule states that if an individual is receiving compensation to provide advice that is individualized to a particular plan sponsor (employer), plan participant (employee), or IRA owner with respect to any retirement investment decision (including all rollover recommendations), then the individual will be considered a fiduciary. A fiduciary is required to work impartially and provide advice in the best interest of his or her client.[18] He or she is also not permitted to receive payments that could be considered a conflict of interest without a prohibited transaction exemption (PTE).[19] Under federal law, those who are considered to be fiduciary under ERISA carry significantly more legal and regulatory liability than those who are not, increasing costs for the fiduciary and his or her customers.

If adopted, the proposed regulation will cover a wider range of professionals who work in the retirement investment industry such as broker-dealers, insurance agents, and pension consultants who may not be currently considered fiduciaries under ERISA but are subject to extensive federal and state legal obligations and oversight.[20]

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14 Mahnaz Mahdavi and Nicholas Horton, "Financial Literacy among Educated Women: Room for Improvement," Journal of Consumer Affairs, Summer 2014, Issue 2, pg.40-417.

15 Carlo de Bassa Scheresberg, Annamaria Lusardi and Paul J. Yakoboski, "Hispanic Personal Finances: Financial Literacy and Decisionmaking Among College Educated Hispanics," TIAA-CREF Institute, May 2015. https://www.tiaa-crefinstitute.org/public/institute/research/hispanic-personal-finances-financial-literacy

16 AnnaMaria Lusardi and Olivia Mitchell, "Financial Literacy and Retirement Planning in the United States," Journal of Pension Economics and Finance, Cambridge University Press, vol. 10(04), pages 509-525, 2011.

17 "Investment Advice-Participants and Beneficiaries," Federal Register, 10/25/2011, https://www.federalregister.gov/articles/2011/10/25/2011-26261/investment-advice-participants-and-beneficiaries#h-27

18 A fiduciary duty is also the highest standard of duty under the law that requires 24-7 vigilant behavior.

19 DOL has included in the re-proposed rule, a new prohibited transaction exemption known as the "best interest contract exemption." Under this exemption, as long as the individual adviser commits to putting the client's best interest first and to supply all disclosures regarding potential conflicts and hidden fees, he or she is allowed to collect commissions and revenue sharing payments.

20 Comments submitted by the Financial Industry Regulatory Authority (FINRA) provide a detailed list of the current federal securities rules that apply to professionals in the investment industry and are available at: http://www.dol.gov/ebsa/pdf/1210-AB32-2-00405.pdf. For more detail on both Federal and State level rules see "Study on Investment Advisers and Broker-Dealers," U.S. Securities and Exchange Commission, January 2011, available at: https://www.sec.gov/news/studies/2011/913studyfinal.pdf

When it was first introduced in 2010, the DOL rule encountered considerable pushback and was withdrawn in 2011. The major issue then and now has been the PTE rules that may effectively raise costs and cut off access to professional advice for smaller accounts. To help alleviate this problem, DOL introduced the Best Interest Contract exemption (BICE) in the re-proposed rule. The specific requirements of the BICE are widely seen as impractical and unworkable due to their burdensome nature. In addition, according to Financial Industry Regulatory Authority (FINRA), the DOL's proposed requirements could create up to six sets of rules for the same financial adviser, depending on which accounts they serve.[21]

The significant compliance challenges, coupled with the potential increase in regulatory and liability costs may result in firms not using the BICE – effectively eliminating commission compensation in favor of a more expensive fee for service model. The impact will mean that low- and middle-income savers may have to pay more for retirement advice, and this could make advice unaffordable for many. As a result, the re-proposed rule is the subject of a contentious debate.

What are the Differences between the 2010 and 2015 Rules?

There are a number of differences between the rule introduced in 2010 and the reintroduced rule. The major differences noted by experts are:[22]

- While the 2010 proposal preserved rules that allow for investment education, there are significant restrictions in the 2015 proposal. For example, when discussing recommended asset classes (such as large cap funds, small cap funds, or bond funds), financial institutions often provide examples. Under the 2010 proposed rule, examples would be considered education that would not trigger fiduciary status. However, under re-proposed rule, providing an example would be considered fiduciary advice.

- The 2010 proposal allowed direct marketing by financial institutions to sell products to small businesses and individuals. The new proposal does not allow direct marketing.

- The 2010 proposal allowed financial institutions to provide assistance for distribution and rollover. The 2015 proposed rule does not.

- Prohibited transaction exemption relief was introduced in the new rule. However many believe it is too cumbersome to be useful.

Why was the Rule Proposed?

The dynamic between investors and financial advisers has been a point of interest for various academic studies. Earlier this year, the White House Council of Economic Advisers (CEA) lent its support to the DOL fiduciary rule by summarizing the academic literature on the cost of conflicted advice on retirement savings, especially for IRA account holders.[23] The main point in the CEA report was that investment returns of mutual funds sold through "conflicted" intermediaries are lower than returns on funds sold directly to savers. In addition, "conflicted payments" may also drive investment decisions. Based on various studies, CEA claimed that investment underperformance is equivalent to 100 basis points, which translates to a cost of $17 billion per year.

The Regulatory Impact Analysis (RIA)[24] conducted by the DOL follows a similar approach and assumes that the rule will eliminate the underperformance difference that results in a benefit to investors of $4 billion per year. The Department recognizes some compliance cost but asserts that even if the 50 percent of underperformance

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21 FINRA, pg 4, http://www.dol.gov/ebsa/pdf/1210-AB32-2-00405.pdf

22 Kent Mason, "Testimony before the Subcommittee on Health, Labor and Pensions for the Hearing Entitled "Restricting Access to Financial Advice: Evaluating the Costs and Consequences for Working Families and Retirees," June 17, 2015, http://edworkforce.house.gov/uploadedfiles/testimony_mason.pdf

23 The Council of Economic Advisers, "The Effects of Conflicted Investment Advice on Retirement Savings," February 2015, https://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf

24 The Department of Labor, "Fiduciary Investment Advice: Regulatory Impact Analysis," April 2015, http://www.dol.gov/ebsa/pdf/conflictsofinterestria.pdf

is eliminated, the gains would be a couple of times larger than the compliance cost, and that the proposal would result in overall gains.

The quantitative analyses by both the DOL and CEA have been criticized for a number of reasons. Some of the criticisms are:

• There is a difference in the total amount of IRA assets providing payments that could be considered as generating conflicts of interest in the two studies (CEA $1.7 trillion, RIA $1.5 trillion). The difference is important because the overall cost of the rule is based on the asset total and the perceived investment underperformance.

• The CEA report uses highly nuanced and complicated academic studies to make simplified generalizations to reach to their cost calculations. For example, in one of the papers used, the authors were comparing the returns for the year when the funds were purchased, but CEA uses the results for all the years that the funds were held.[25]

• The underperformance amount changes when the funds under study change, such as shifting from domestic to international equity, or when different time frames are considered.[26]

• To make their case regarding the fees in IRA accounts, CEA authors assume that while a typical 401(k) plan investor pays fund expenses around 20 basis points, for an IRA rollover, the same fee is 130 basis points, creating a difference in fees of 110 basis points. However, analysis of actual data by Investment Company Institute[27] shows that this difference is only 17 basis points, which raises questions regarding the CEA calculations.

However, the most important critique of both reports is that both analyses ignore the benefits associated with financial advice, especially for small savers and small businesses. As already noted in this report, in 2011 DOL acknowledged that financial losses from investment mistakes amounted to more than $114 billion in 2010.

Value of Financial Advice

Whether it is due to behavioral reasons or lack of financial knowledge, as described in previous sections, the savings habits of U.S. households are less than perfect. As a result, in many cases, account balances are too low. (See Figure 3) However, the data and research show that people who work with financial advisers do better than their counterparts who do not have access to financial advice. Research suggests:

• Financial advisers may help individuals improve their saving behavior, similar to how a personal fitness trainer helps with weight management. In many cases, the relationship between investor and advisor sets a precedent for a long-term investment strategy. The data show that advised individuals have a minimum of 25 percent more assets than non-advised individuals.[28] A recent Investment Funds Institute of Canada report shows the trend holds regardless of household income, and that advised households save at twice the rate of non-advised households.[29]

• Financial advisers may help clients pick more tax efficient investment options.

25 NERA Economic Consulting, "Review of the White House Report Titled "The Effects of Conflicted Investment Advice on Retirement Savings," March 2015, http://www.nera.com/content/dam/nera/publications/2015/PUB_WH_Report_Conflicted_Advice_Retirement_Savings_0315.pdf

26 Robert Litan and Hal Singer, "Good Intentions Gone Wrong: The Yet-to-be-Recognized Costs of the Department of Labor's Proposed Fiduciary Rule," July 2015, Economists Incorporated, http://www.dol.gov/ebsa/pdf/1210-ZA25-00070.pdf

27 Brian Reid, Statement of the Investment Company Institute, Hearing on "Restricting Access to Financial Advice: Evaluating the Costs and Consequences for Working Families and Retirees," June 17, 2015. http://edworkforce.house.gov/uploadedfiles/testimony_reid.pdf

28 Oliver Wyman, "The Role of Financial Advisors in the U.S. Retirement Market," July 10, 2015. http://fsroundtable.org/wp-content/uploads/2015/07/The-role-of-financial-advisors-in-the-US-retirement-market-Oliver-Wyman.pdf

29 The Investment Funds Institute of Canada, "The Value of Advice Report," 2012, https://www.ific.ca/wp-content/uploads/2013/02/IFIC-Value-of-Advice-Report-2012.pdf/1650/

• Through their experience, financial advisers may help investors protect against poor financial decisions, and rebalance their portfolio with market changes in line with their long-term goals. According to a study by Ralf Gerhardt and Andreas Hackethal using data on 65,000 customers of a large German bank, individuals receiving advice become involved with less risky and speculative trading, and have more diversified portfolios.[30]

• In the case of retirement planning, financial advisers may help the saver choose a portfolio with the appropriate level of risk for his or her age. They may also help design a spending strategy for the retirement years that help the retiree avoid running out of money.

Researchers at Vanguard suggest that through behavioral coaching, rebalancing, diversification, and other best practices, financial advisors may add as much as 3 percent net return for their clients.[31] According to Vanguard's numbers, the net value of financial advisers would be more than the cost of conflicted advice envisioned by both the CEA and DOL.

Unintended Consequences of DOL Rule

Financial advice helps overcome some of the impediments to saving discussed in previous sections. Ignoring the value of financial advice has important implications both for the current savings of workers and their future retirement security.

Possibility of Cost Increases and the Impact on Financial Advice:

U.S. data indicates that there is a strong demand for financial advice. According to ICI, in mid-2014, 80 percent of U.S. households that owned mutual funds purchased their funds through an investment professional, such as registered investment advisers, full-service brokers, independent financial planners, bank and savings institution representatives, insurance agents, and accountants.[32] Many households prefer brokerage services due to their cost advantage compared to advisory services. Table 2 describes the differences between the two models, both in terms of the level of service and cost.

Investors tend to choose between different levels of service depending on the size of their account: while many high balance account owners are associated with more comprehensive and costly advisory services, small- and medium-size accounts prefer less costly, transaction-based brokerage services. The grouping is apparent in the data on IRA accounts. According to a recent Oliver Wyman study, 66 to 99 percent of IRA accounts used brokerage services, depending on account size; with a higher share of high-value accounts choosing advisory IRAs (see Figure 4).[33]

The adoption of a comprehensive fiduciary standard will likely increase the cost of service, especially for small- and medium-sized accounts holders. The prospect of increased recordkeeping and paperwork for compliance purposes, as well as the possible increase in litigation volumes, will push up the cost for brokerage services, making them uneconomical, especially for small account sizes. The Oliver Wyman (2015) study estimates that costs may increase between 73 and 196 percent.[34] The increased costs could result in some accounts switching to advisory services; however, many investors will lose access to the financial advice.

Increased Leakage of Assets during Job Switch:

Short job tenures, especially among millennial savers, require decisions about what to do with

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30 Ralf Gerhardt and Andreas Hackethal, "The Influence of Financial Advisors on Household Portfolios: A Study on Private Investors Switching to Financial Advice," February 2009, Social Science Research Network, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1343607

31 The best practices include: suitable asset allocation using broadly diversified funds, cost-effective implementation (expense ratios), rebalancing, behavioral coaching, asset location, spending strategy, total-return versus income investing. Among these strategies, the highest value belongs to behavioral coaching with 1 to 2percent additional value. See Vanguard, "Putting a Value on Your Value: Quantifying Vanguard Advisor's Alpha," March 2014, http://www.vanguard.com/pdf/ISGQVAA.pdf

32 2015 Investment Company Fact Book

33 Oliver Wyman, "Assessment of the Impact of the Department of Labor's Proposed "Fiduciary" Definition Rule on IRA Consumers, April 2011, http://www.dol.gov/ebsa/pdf/WymanStudy041211.pdf

34 Oliver Wyman, 2015.

Table 2. Key Attributes of IRA Business Models

Key Attributes	Advisory	Brokerage	
		Full Service	Discount
Investment services needs	Broad financial planning and investment advice	Product-specific investment information, access to principally-traded products and range of third party and proprietary products	Product-specific investment information, access to principally-traded products and range of third party and proprietary products
Level of service	Personalized access to an investment professional Highest ongoing advice and account surveillance	Personalized access to an investment professional Information to help investors set up an IRA account and select suitable investments	Often offer access to an investment professional through a branch or call center Online investment information, research, tools and calculators to help investors set up an IRA account and select suitable investments
Cost	Tends to be highest cost	Balanced cost, with costs based on level of trading activity	Lowest cost, depending on trading activity

Source: Oliver Wyman, "Assessment of the Impact of the Department of Labor's Proposed "Fiduciary" Definition Rule on IRA Consumers, April 2011, http://www.dol.gov/ebsa/pdf/WymanStudy041211.pdf

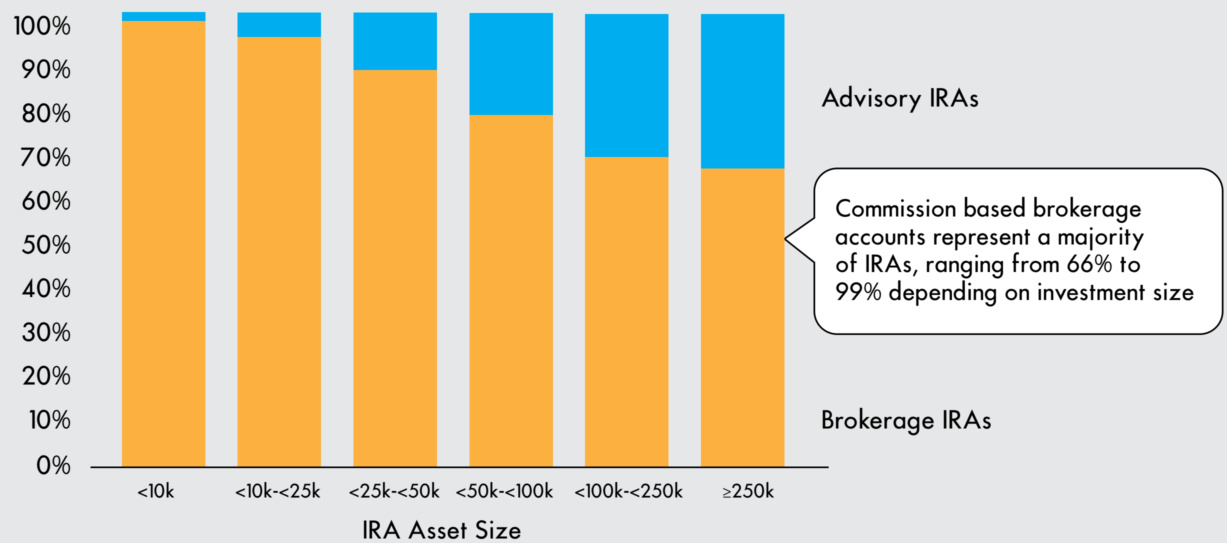
retirement assets that are accumulated with previous employers. Employees have the option of leaving their funds with their old employer, transferring it to a plan with their new employer, rolling it into an IRA, or taking cash out when they change jobs. According to a GAO report, some plan sponsors do not want to retain separated employees' accounts due to administrative burdens, costs, and legal liabilities.[35] Employees often do not want to leave their retirement assets within a former employer's plan, although the paperwork that is required to roll into a new account can be a burden for some employees. Many young workers take the path of least resistance and take the cashout, especially if their account balances are low. According to a 2011 survey:[36]

- 42 percent of terminating employees took a cash distribution
- 29 percent rolled their savings into a new plan or an IRA; and
- 29 percent left their funds with their previous employer

Financial advice becomes crucial at the point of rollover and helps keep savings intact. Employees are less likely to take cash distributions if they are guided by financial advice. In fact, one company found that when terminating employees were contacted by a licensed representative of a financial company by phone, they were 3.2 times less likely to take a cash distribution compared to a similar worker who received

35 GAO, "401(K) Plans: Labor and IRS Could Improve the Rollover Process for Participants," March 2013, http://www.gao.gov/products/gao-13-30
36 AON Hewitt, "Leakage of Participants' DC Assets: How Loans, Withdrawals, and Cashouts Are Eroding Retirement Income," 2011, http://www.aon.com/attachments/thought-leadership/survey_asset_leakage.pdf

Figure 4. Investors Prefer Transactional, Commission-Based Brokerage Accounts over Asset-Based Fee Advisory Models for IRAs



Source: Oliver Wyman, "Assessment of the Impact of the Department of Labor's Proposed "Fiduciary" Definition Rule on IRA Consumers, April 2011, http://www.dol.gov/ebsa/pdf/WymanStudy041211.pdf

only written communications.[37] However, the DOL rule could inhibit communication between licensed representatives like broker-dealers and employees by requiring the broker-dealer to become a fiduciary. Inhibiting these communications will increase the likelihood that terminating employees will cash out their crucial retirement savings. By some calculations, a dearth of educational communications to transitioning employees could result in an additional $20 to $32 billion of cash-outs annually, decreasing the retirement savings of affected individuals by 20 to 40 percent.[38]

Access to Workplace Retirement: DOL Rule and Small Businesses:

As discussed in previous sections, for many individuals access to workplace retirement plans plays a key role in saving for retirement. However, for many small businesses, DC plans are not affordable due to their administrative complexity, costs, or eligibility requirements. To provide retirement benefits to their employees, small businesses rely on different types of IRAs that are cost-efficient and easy to operate. The availability of financial advice, especially for setting up IRAs for small businesses, is very important to help guide small businesses. In fact, when a financial adviser is involved, a small business with 10-49 workers is 50 percent more likely to set-up its own retirement plan. Smaller businesses are twice as likely to set up their own retirement plan with the help of financial advisers.[39] However, the DOL rule could hinder the ability of small businesses to set up retirement plans. The exception in the current rule that allows for sales activity (when sellers clearly communicate that they are selling a product) does not apply to individuals and small businesses. Many experts think that the lack of a clear seller's exception will limit or discourage many small businesses from starting a plan, negatively impacting the public policy goal of increasing access to retirement plans.[40]

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37 Quantria Strategies, LLC, "Access to Call Centers and Broker Dealers and Their Effects on Retirement Savings," April 2014, http://quantria.com/DistributionStudy_Quantria_4-1-14_final_pm.pdf
38 Quantria, 2014.
39 Oliver Wyman, 2015.
40 Bradford P. Campbell, "Locked Out of Retirement: The Threat to Small Business Retirement Savings," June 2015,U.S. Chamber of Commerce, http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/US-Chamber-Locked-Out-of-Retirement-White-Paper.pdf

Investment Education and the DOL Rule:

The lack of financial knowledge among U.S. households makes investment education critically important for a secure retirement for U.S. employees. Under current rules, investment education can include guidance on which asset classes individuals should invest in based on their age and other factors. Educational materials can also provide specific investment examples for each asset classes. The re-proposed DOL rule would not allow specific examples, considering them fiduciary advice. For many individuals abstract or hypothetical discussions without examples can lead to confusion, making choices more difficult. Not properly diversifying one's portfolio based on age and long term goals could result in less than optimal retirement savings.

The DOL regulations could introduce a significant burden on retirement assets. When unintended consequences are quantified, one analysis shows that the re-proposed rule could decrease retirement savings between $68 and $80 billion each year.[41] Similarly, Litan and Singer (2015) show that even under more optimistic scenarios, the cost of the DOL rule would always exceed the benefits claimed by both the CEA and DOL studies, even if human advice was replaced by computers through robo advisers, which provide automated financial advice with minimal human involvement. Automated advice may be right for some savers, but will prove to be insufficient for individuals needing more substantive guidance, such as those trying to save for retirement while also saving for a child's education and caring for an aging parent.

Conclusions

U.S. retirement markets are continuously evolving with changing demographics as well changing economic realities. While there has been an increasing reliance on DC plans and IRAs and these plans have continued to grow, there is still a significant share of the U.S. work force that either do not have access to such plans or are not taking full advantage of what they have. A comprehensive retirement policy designed to maintain growth in savings, expand coverage, and prevent leakage during job changes is imperative for retirement security. The recently re-proposed DOL fiduciary rule, meant to protect the retirement savings of individuals, might not be in consumers' best interests. The DOL rule should be more fully analyzed and adjustments made to ensure that low- and moderate income individuals are not priced out of personalized guidance and advice.

41 Quantria Strategies, 2015.