Summary

For many financial products (for instance, insurance savings products), the product's quality is not immediately obvious to the buyer at the point of purchase. Financial advisers who retail these products are frequently rewarded with sales commissions that vary widely across apparently similar products. This leads to concerns about the mis-selling of financial products: The popular view is that financial advisers have an incentive to sell whatever product earns the highest sales commission, instead of giving unbiased buying advice.

In this paper, I point up a simple argument that breaks the connection between sales commission and biased advice. Even if financial advisers are interested purely in maximizing commission income, there is no problem of mis-selling of financial products if the best products earn the adviser the highest sales commission. In this case, even a purely commission-maximizing adviser gives the "right" advice.

The link between high-quality products and high sales commissions comes from a signaling model in which the producers of financial products have to attract initial buyers and in which owners of the product use any information they obtain about the quality of the product to make decisions about surrendering the financial product early, or continuing (or repeating) purchase. The argument is that owners of high-quality products will find out that they own a high-quality product, and will continue to purchase the product.. Owners of low-quality products will find out that they own a low-quality product, and will surrender the product early. Attracting an initial buyer is therefore worth more to the producer of a high-quality product than to the producer of a low-quality product. Since commission payments are just a way of attracting an initial purchaser, a high-quality producer is willing to pay higher sales commission to its retailers than a low-quality producer.

The crucial point in the argument is that owners need to be able to obtain information about the quality of the product that they have purchased. If a buyer will never know whether her financial adviser has provided good or bad advice, the signaling intuition no longer holds. This allows me to predict for different ways of modeling the behavior of returns to financial products over time whether commission payments contain information about the product's quality or not. Briefly, if today's returns contain information about yesterday's returns (for instance, because the returns follow a random walk), then the signaling intuition holds. The paper works through different plausible assumptions of the behavior of the returns of savings products.