Information Asymmetry in Wealth Management—Moral Hazard Risk

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The fundamental challenge faced by Private Family Offices (PFOs) when managing wealth is linked to trust. Trust is developed through repeated successful transactions, and to achieve trust, transparency is critical.

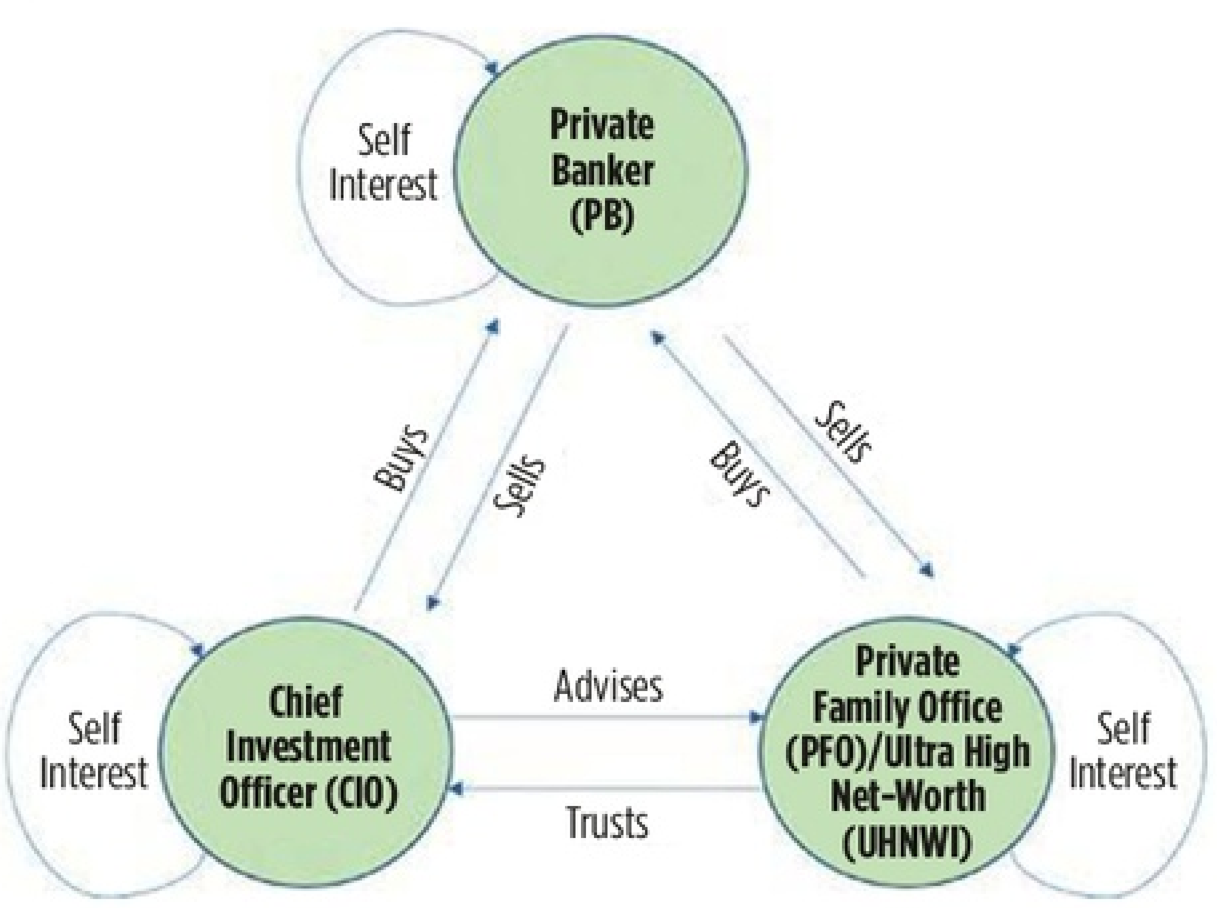
In order to address this information asymmetry moral hazard risk, it is essential to enforce transactional transparency of all wealth advisors, be they internal or external (see Figure 1). Towards that, author and his team have interacted with tens of principals in various markets around the world and found that formal and informal arrangements on how the wealthy seek advice varies drastically from mature markets (USA/Europe/Japan) to relatively immature markets (GCC, Southeast Asia, Africa).

In mature markets the internal advisors or CIOs are highly qualified individuals and are incentivized around base compensation + performance. However, this is not generally the case in less mature markets where internal advisors are typically not highly qualified, and in-house accountants are relied on as financial advisors without much distinction between the two.

Thus, we have come across several circumstances during dealings with principals where information asymmetry has resulted in risks which would be considered "moral hazard" scenarios. One key area is how advisors are incentivized. In several instances our data has shown that given the self-interest of external advisors, they are driven purely by selling their own in-house financial products and not necessarily the best performing or most-suited financial products for their clients.

Similarly, we have also observed that in-house advisors in emerging economies are equally driven by self-interest. This is evident by product recommendations when internal advisor self-interest was aligned with the external advisor, or the lack of transparency in terms of their own communication internally on what they advise to Family Patriarchs/Matriarchs. ■

Figure 1: Motivation diagram from the general principal agent framework in microeconomic theory.



Self-interest drives possible moral hazard related risk to the principal (PFO). **The author through his interactions with various clients has come across such risks in various instances,** such as when the self-interest of internal advisors/CIO or external PB (agent) can also be scrutinized for moral hazard situations (i.e. questionable investment advice to the family patriarch/matriarch).

Omar Rana, Co-Founder of Finalytix, his prior work includes corporate strategy at Fortune 500 companies in various markets globally and was the Chief Investment officer for a large private family office in the GCC where he was responsible for the Private Equity strategy and the management of $500M in investments. He is also an alumni of the Harvard Business School.

About Finalytix

Finalytix Inc. is an early stage startup which has built a solution for Ultra-HNWIs and Family Offices to help manage their global consolidates assets across wealth advisors and holdings covering all asset classes including real-estate. By leveraging detailed transactional fields, Finalytix consolidates financial data and provides insights on critical information which is typically not made evident by advisors, such as breakdown of fees and linking fees to performance, thus helping in reducing the information asymmetry – moral hazard risk.

Learn more at www.finalytix.com or contact engage@finalytix.com.