EValue

How to **establish a client's capacity for investment risk**

Introduction

In this fourth guide of our 'How To' series for advisers we will be looking at establishing a client's capacity to accept investment risk as part of the process of identifying their risk profile.

The Financial Conduct Authority (FCA) and its predecessor, the Financial Services Authority (FSA), have been keeping a watching brief to ensure that fund recommendations match adviser clients' risk profiles. In March 2011, the FSA issued guidance on 'assessing customer risk and investment suitability'. It stated, amongst other things, that recommendations must reflect the level of risk a customer is willing and able to take.

This guide concentrates specifically on how advisers should consider their clients' ability to accept investment risk.

Following the 5 steps in this guide will ensure that an investor's true capacity for risk has been taken into account as part of the advice process.

We will begin by considering what exactly is meant by capacity for risk and where, in the advice process, it is likely to be discussed. We will then look at examples of circumstances which are likely to affect a client's capacity for risk. Finally we will consider what help is available to assist with this part of the advice process.

Step 1: Understand what is meant by capacity for risk

Risk profiling is intended to establish the amount of investment risk a client is willing and able to take. Their willingness to accept risk (their "attitude to risk") is normally identified through the completion of a psychometric risk questionnaire. This results in a score that determines the client's provisional risk profile.

Capacity for risk, however, reflects the client's ability to accept the level of risk identified from the attitude to risk questionnaire. It takes account of circumstances in the client's life that could affect his or her capacity for risk, either now or in the future.

The outcome of the risk questionnaire may show that a client is willing to accept a very high risk investment strategy but this may be completely unsuitable if all of the investment represents their total life savings. In fact, where a loss of capital would have a materially detrimental effect on a client's standard of living, the FCA requires this to be taken into account in the assessment of the risk the client is able to take.

It is also important to appreciate that a client's capacity for risk may differ according to the 'pot' of money being considered. For example, a pension fund that is not required for, say, 30 years may be treated quite differently from money needed for a child's education in 10 years' time.

Step 2: Comprehend where capacity for risk sits in the advice process

Establishing a client's risk profile is an essential part of the advice process. This advice may include the introduction of new funds to a portfolio or the redirection of existing investments to new funds or products.

Risk profiling forms part of the fact find process which is likely to consist of the following elements:

Agree attitude to risk + Discuss capacity for risk + Link to client objectives

This guide concentrates on the second element, capacity for risk.

Step 3: Assess the factors that can affect a client's capacity for risk

A number of factors could impact upon a client's capacity to accept investment risk, such as:

Proportion of wealth to be invested. Suppose, for example, that there are two investors, each with £50,000 available to invest. With client 1 this represents 90% of their entire liquid assets. For client 2 it is just 20%. Based solely on this information, client 1 is in a more vulnerable position if the value of their new investment was to suddenly reduce.

Financial dependants. The number of dependants should be taken into account as well as the likely period of their dependency. For example, a client with a young child is likely to have a much greater level of on-going commitment than one whose child is about to leave university and move straight into a job. Another factor could be a client having a child who will always be dependent on them, maybe due to physical or mental illness.

On-going financial commitments. The amount and time period remaining for outstanding debts, such as mortgages, should be taken into consideration. For example, will the money currently being considered for investment be needed to repay some or all of these liabilities?

Emergency funds. It is generally recognised that, before committing money to long-term investment, consideration should be given to short-term emergency situations where cash is likely to be needed. The availability of cash could have a significant impact on a client's capacity to accept investment risk. If, for example, money that is invested is needed at short notice, then the potentially greater short-term volatility of a higher risk investment may be inappropriate for certain clients, despite their attitude to risk.

Day to day living expenses. A client's dependency on their investments to supplement on-going income is the main factor here. Potentially, the greater the reliance on capital to support income then the lower the client's capacity to accept investment risk is likely to be.

Investment experience. The level of understanding about investments that a client has, based on previous experience, may also affect their capacity for risk. The greater their knowledge, the more they are likely to appreciate the impact of risk on future returns.

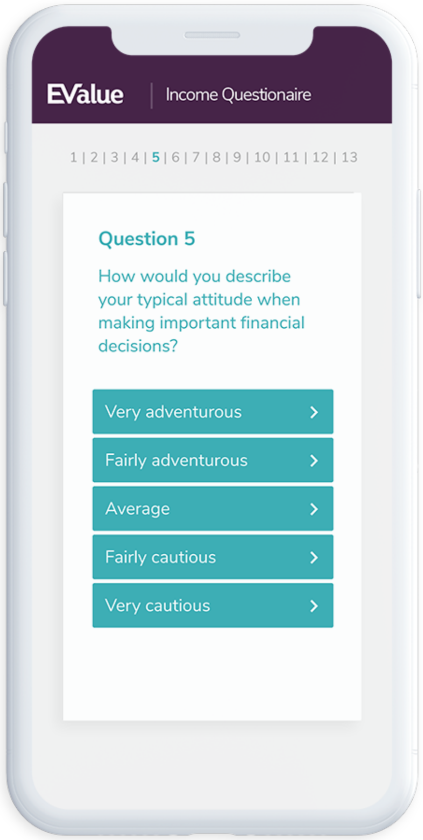
These factors are not intended to be an exhaustive list. They do, however, highlight the importance of a detailed discussion between adviser and client before any investment decisions are made. These are all points that can be identified and discussed during the fact finding process.

A client's attitude to risk is normally derived by the completion of a psychometric risk questionnaire, with a choice of responses offered. The answers, given by the client, result in a score being allocated which corresponds to a specific risk profile. It is, therefore, a formulaic process based on parameters set out by the risk profiling system being used.

Step 4: Develop a process to establish capacity for risk

However, capacity for risk is a client's ability to take on investment risk and should be treated quite differently. Good practice requires a company to use one process to assess a client's attitude to risk and a separate process to assess the client's capacity for risk, whilst ensuring both are appropriately considered as part of a suitability assessment.

No scoring system is involved when establishing a client's capacity for risk. Instead, a discussion is held between adviser and client. This discussion should focus on particular aspects of the client's circumstances that currently, or may in the future, impact on their capacity to take investment risk. One method may be to use additional capacity for risk questions which are included separately but form part of the overall risk suitability process, such as those shown. In order that an audit trail can be demonstrated following any advice given, advisers should ensure that the client discussion is fully documented, as shown in this example.



Step 5: Help the client identify his or her capacity for risk

It is clear that agreeing a client's capacity for risk is very much an individual consideration. Two clients with seemingly similar requirements may end up with different risk rated solutions after an in-depth discussion, due to their own specific circumstances. Let's consider the following two clients, for example:

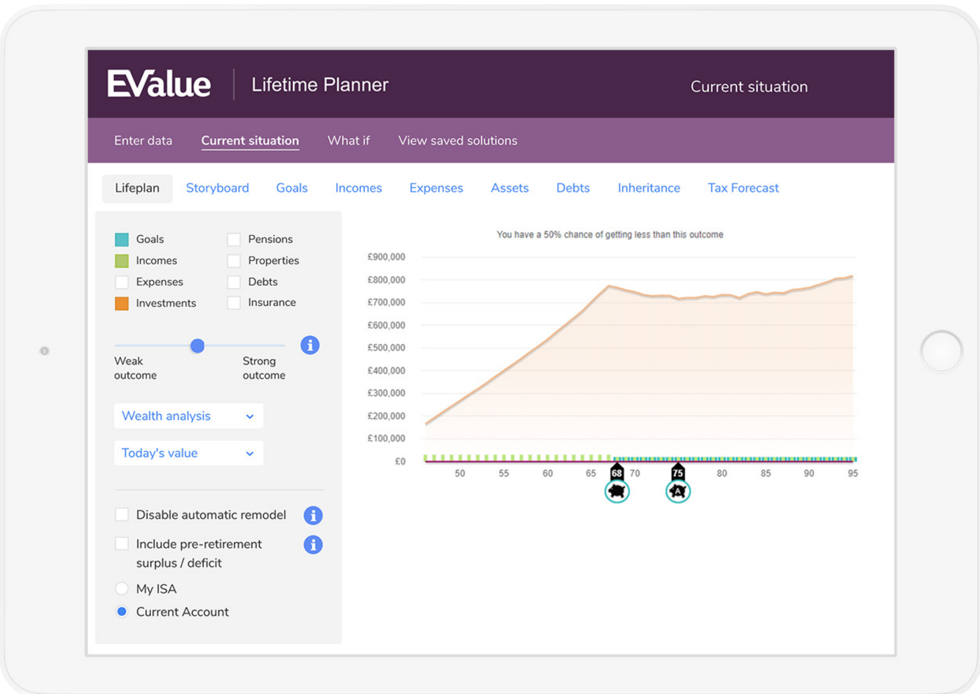
- Both are 60 years of age and have £100,000 available to invest. Each has an attitude to risk rating of '7' out of 10, using the eValue 'standard 10' risk benchmark.
- Client 1 has £10,000 available as emergency funds whereas client 2 has £50,000.
- Client 1 has little previous investment experience; client 2 has regularly made her own investment decisions.

Based on these details alone, it would appear that client 2 has greater capacity for risk and should therefore be advised to take a more adventurous approach to their investment. There is, however, some further information about each client that needs to be taken into account before any investment decision is made:

- Client 1 has no financial dependants; client 2 has a disabled son aged 25, who will always be reliant on her.
- Client 1 has no on-going financial commitments; client 2 has a mortgage with an outstanding balance of £90,000.

It is now less clear which, if either, client has the greater capacity for risk. This emphasises the point that a thorough and properly documented discussion is essential before a final outcome can be confirmed.

The use of a 'cashflow' modeller, such as EValue's Lifetime Planner, is also likely to be a valuable source of information in analysing a client's current and on-going financial position. This will help to identify times of potential shortfalls in income which will, undoubtedly, have an impact on their capacity for risk.



The EValue approach

This guide has highlighted the fact that establishing a client's capacity for risk is a process that requires considerable attention to an individual's personal requirements and circumstances. It requires a high degree of skill on the part of the adviser to ascertain from their client sufficient knowledge in order to understand exactly what their financial position is and what is most important to them.

Establishing a client's capacity for risk is an in-depth process which is a clear priority for advisers and a requirement of the FCA. Ultimately, it ensures that the advice given will be of a high standard and tailored to an investor's own specific needs and circumstances.

We hope you found this eValue 'How To' Guide helpful. Look out for others appearing on our website at ev.uk where you can also find details about our range of EValue's Advisa Centa solutions.

If there is subject you'd like to know more about, then we'd love to hear from you. Please email us directly: contact@ev.uk

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