AXA Wealth

A framework for assessing **capacity for loss**

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AXA WEALTH
redefining / standards

Unsure about assessing capacity for loss? You're not alone

When it comes to planning your clients' retirement, we're here to help.

Understanding the level of risk that's appropriate for them to take always has been, and always will be at the heart of your advice. In the past, the focus was on your client's attitude to risk, but equally important is assessing their ability to absorb falls in the value of their investment – or their capacity for loss.

For many advisers, while the question of how to measure a client's attitude to risk is well-trodden ground, assessing their capacity for loss and demonstrating good practice in doing so, can be more challenging.

This focus is particularly important for older clients who will rely on their investment portfolio to provide an ongoing income in retirement. They need an income stream that is sustainable during their later years while also trying to avoid some of the risks in retirement, such as the dangers of market falls and pound-cost ravaging.

Clients need to appreciate and understand the trade-offs that are involved in setting up an investment to cover their wants and needs, and be comfortable with the investment decision that's ultimately made.

Built on research I've undertaken, the capacity for loss framework aims to support your fact finding discussions with clients, so that you're exploring the variables that can impact them. It will also demonstrate how capacity for loss should be considered in tandem with their attitude to risk, and how this analysis is imperative to setting appropriate objectives for your clients, and ultimately completing an accurate suitability report.

Thank you for reading.

John Makin

Senior Technical Consultant at AXA Wealth

This capacity for loss framework aims to...

- Highlight the latest **Financial Conduct Authority (FCA) guidelines**
- Uncover findings from our **research**
- Consider capacity for loss **assessment methods**
- **Support your fact find** with common capacity for loss discussion themes
- Assist with the assessment of risk tolerance and capacity for loss in **tandem**
- Demonstrate through **case studies**

FCA – the current picture

> “Firms need to…ensure that the portfolios they manage truly reflect the investment needs and risk appetites of their customers, especially those who have a limited capacity for, or desire to expose themselves to the risk of, capital loss.”
>
> **Financial Conduct Authority Thematic Review 15/12:** Wealth Management firms and Private Banks – suitability for investment portfolios.

The Financial Services Authority first raised a concern around capacity for loss in 2011, a position its successor, the Financial Conduct Authority, has maintained.

In its 2016/17 Business Plan published in April 2016, the FCA stated it would be writing to around 700 advice firms ahead of a supervision exercise focusing on the suitability of their advice. This process was to include reviewing copies of suitability reports and the way in which firms document their investment and research processes.

Despite the regulator’s guidance, there still seems to be a grey area when it comes to adviser firms assessing and documenting their clients’ capacity for loss.

Capacity for loss has been a growing concern for the FCA for some time

Research undertaken by Architas in 2011 suggested that just 18% of financial advisers were comfortable with the then FSA’s guidance. Further research we undertook last year suggests there’s still some uncertainty with assessing and documenting capacity for loss when formulating an overall investment recommendation for a client.

Capacity for loss is a pertinent issue that has been regularly talked about in recent years. It boils down to understanding your clients, while taking a multi-faceted approach to fact-finding conversations to not only talk about attitude to risk and capacity for loss, but to use the two in tandem to shape your recommendations.

This framework aims to support this process for you.

Methods for assessing capacity for loss

The starting point is always good fact finding

It's about doing what you do best - getting to know your clients through in depth fact finding discussions, piecing together all the important details of your clients' wants and needs:

- assess their circumstances, goals and objectives
- understand both their attitude to risk and their capacity for loss
- regularly review both aspects, in case their circumstances change.

There isn't a one size fits all approach to assessing capacity for loss. Instead there are a number of methods and tools you can use, including cash flow modelling and capacity for loss questionnaires.

Our research found that both these tools were used by advisers during fact finding conversations with clients. However, they need to be used as part of a wider framework to help you accurately discuss, document and agree your clients' capacity for loss, alongside their attitude to risk and their overall objectives.

Assessing both attitude to risk and capacity for loss are of equal importance when producing a suitability report, and you will need to separate both out in your suitability reports to emphasise the distinctions between the two.

Are you…

- already covering capacity for loss questions in your fact find?
- regularly discussing, documenting and reviewing these key variables?
- happy with the tools you are using to support these discussions?

Could you…

- apply a capacity for loss framework to your wider fact finding process?

A capacity for loss framework

Discussion themes

As part of our research – which builds on existing academic studies detailed in the appendix – we've identified a number of common discussion themes which could be considered when assessing an individual's capacity for loss.

Depending on your clients' objectives, these themes could help provide a more meaningful picture of their capacity for loss. They should be accurately documented, and form part of your suitability report later on.

1. How long do you intend to hold this investment before you start drawing an income from it, or need the capital from it?
2. How much would your standard of living be affected if the income from this investment or the capital sum produced by it were to fall below your expectations? You could consider illustrating the impact through use of a cash flow modelling tool or similar output.
3. If you needed sudden access to a lump sum, how likely would you be to take it from this investment?
4. Investments can go up or down in value and experts often say you should be prepared to weather a downturn. By what percentage could the total value of your investment go down before this would impact upon your standard of living?
5. Approximately how much income do you have remaining each month, after all monthly expenditure?
6. Do you currently have any debts and if so, how much? (short-term debt such as credit cards, car loans; long- term debt such as a mortgage)
7. Are you anticipating any changes to your current financial circumstances?
8. Are you able to save on a regular basis without affecting your standard of living and if so, how much would you be able to comfortably save?
9. Are you in good health?
10. How knowledgeable are you of investments and their risks?
11. How many dependants in your family, besides yourself, do you fully or partially support?
12. Insurance can cover a wide variety of life's major risks; theft, fire, accident, illness, death. How much cover do you have?
13. Think of your net worth as being what you own. This includes your family home and other personal use assets, minus what you owe.
14. What is the value of your net worth? (If you are married or have a partner, please include only your share of jointly owned assets, less your share of what you own jointly).

Assessing attitude to risk and capacity for loss is essential

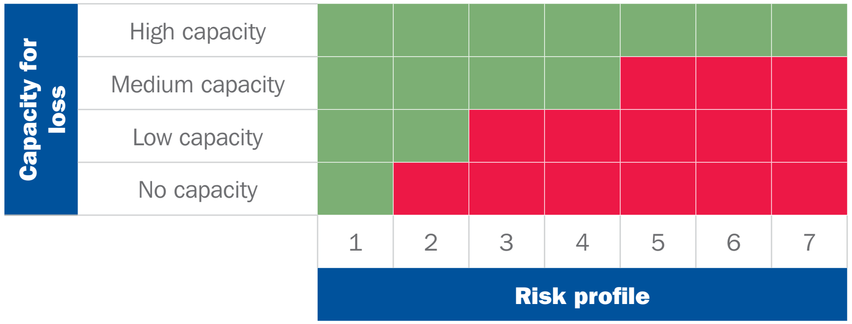
But doing so in isolation could hamper your search for the most suitable investment solution for your client. You need to consider the results of both assessments in tandem to get the full picture when providing your recommendation and producing your suitability report.

A repeatable process of review

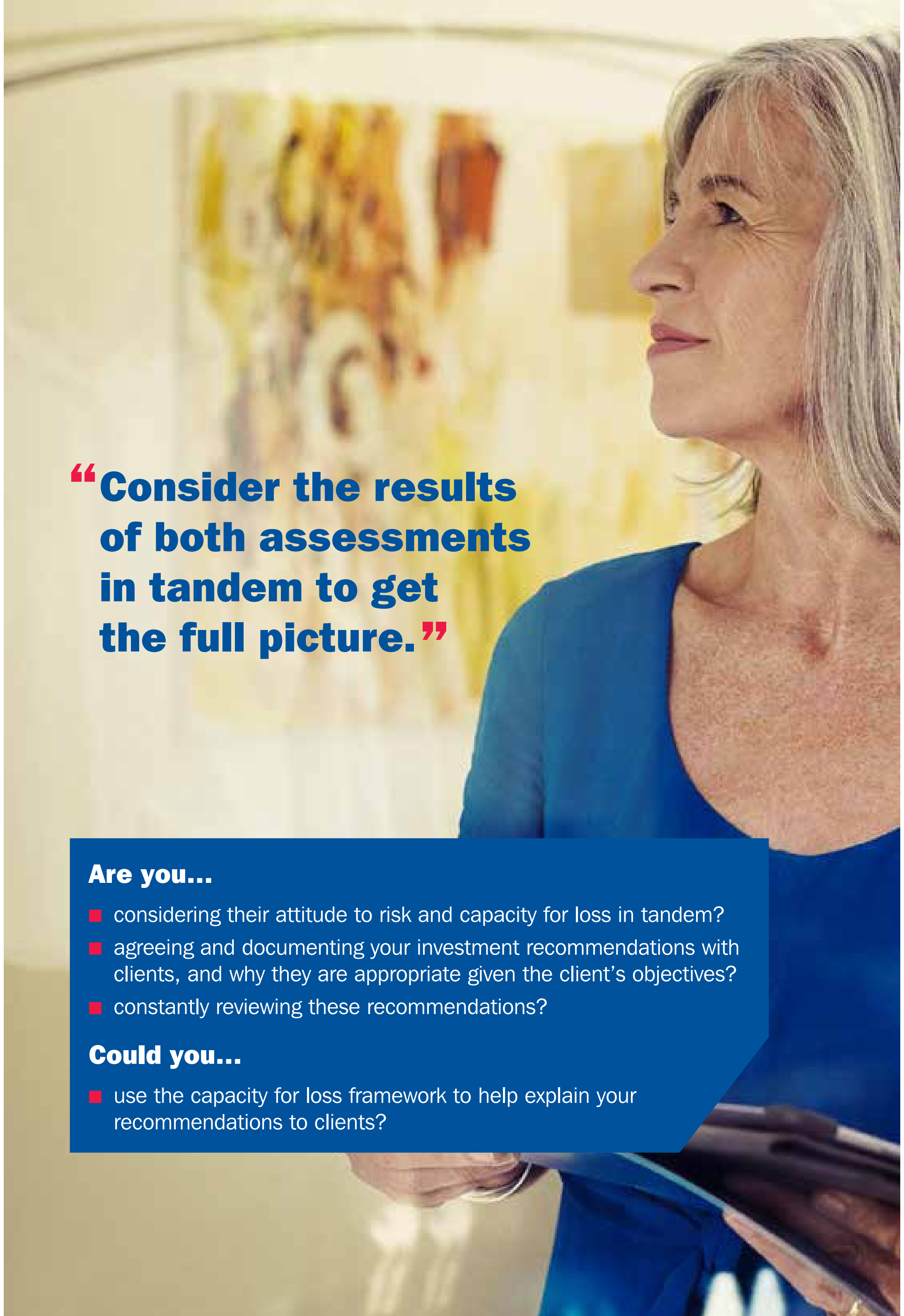
Your expertise at the fact finding stage will help you arrive at an attitude to risk rating and a capacity for loss level that you and your client are comfortable with.

Our research has helped us develop a framework, which you could use to plot an initial indication of a clients' risk rating, against their capacity for loss.

Capacity for loss framework



Red boxes indicate that, given a client's capacity for loss, their suggested risk rating may need further discussion with their objectives in mind.



"Consider the results of both assessments in tandem to get the full picture."

Are you...

- considering their attitude to risk and capacity for loss in tandem?
- agreeing and documenting your investment recommendations with clients, and why they are appropriate given the client's objectives?
- constantly reviewing these recommendations?

Could you...

- use the capacity for loss framework to help explain your recommendations to clients?

Risk profile assessment

For the purposes of this framework we've used the eValue risk scale, which runs from 1-7 (1 being the lowest level of risk, 7 being the highest). This is for illustrative purposes only, and other risk scales are available.

Risk profile						
1	2	3	4	5	6	7

Capacity for loss assessment

You will need to determine your clients' capacity for loss. You can then use the discussion themes in this paper to help you form this assessment. Other capacity for loss tools are also available.

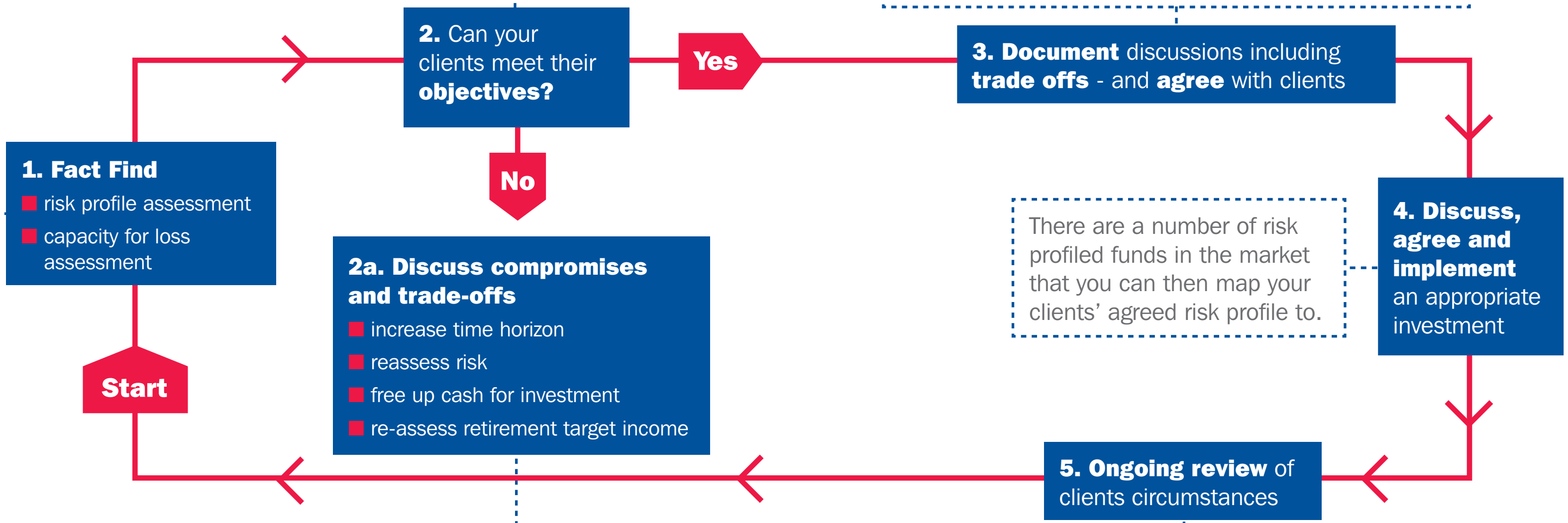
Capacity for loss			
High capacity	Medium capacity	Low capacity	No capacity

Based on your fact-find discussions, you then need to consider whether your clients' objectives are achievable. Plotting your clients' attitude to risk against their capacity for loss will give you a clearer picture on this, and whether they need to adjust their approach in order to meet their life goals.

The framework below allows you to demonstrate to your clients whether their attitude to risk - the risk they are willing to take, and their capacity for loss, the risk they are able to take - is likely to make their goals achievable.

Once you've agreed with your clients that their attitude to risk and capacity for loss in tandem can achieve their objectives, you then need to document and evidence how you got to that decision.

You could consider using the framework to provide a visual representation of your recommendation of how you reached that decision, which your clients can then agree to and approve. It could also be used as a method of signing off a recommendation – an easy to explain, easy to understand visual aide that can give comfort to clients – and the FCA.



There are a number of risk profiled funds in the market that you can then map your clients' agreed risk profile to.

If your clients' objectives don't appear achievable, or their capacity for loss doesn't allow them to take the requisite level of risk, then you will need to go through further fact finding discussions:

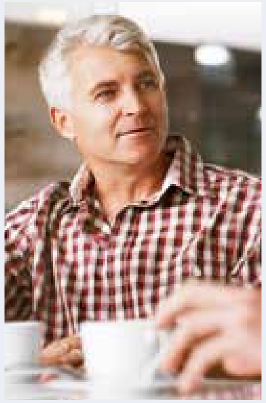
- could they reconsider their risk attitude?
- can they free up some income (forsake a holiday or a new car, perhaps) to meet investment objectives
- could they change their objectives (i.e. delay their retirement plans)?

This part of the process is sometimes difficult to document, but given the FCA's stance on suitability, it is important to do so. Again, the framework can be used to illustrate these discussions.

It's important to remember that is just the start of these discussions. Client's circumstances will constantly change, meaning re-assessment, further discussion over decisions - including trade-offs - are essential.

Capacity for loss framework – case studies

Let's consider some examples of how capacity for loss can impact your fact find and suitability reporting processes. How can you balance your client's capacity for loss and risk appetite while still achieving their objectives?



Bill, 55

Your fact find assesses Bill as follows:

Risk level	Capacity for loss
3	Medium capacity

Bill's situation

Bill plans to retire at 60 which, based on his income requirements and current investments/savings, appears unrealistic. You discuss ways Bill could meet his objectives, but it may be that he has to go outside the parameters of his risk assessment to achieve this.

2. Can they meet their **objectives?**

Yes

No

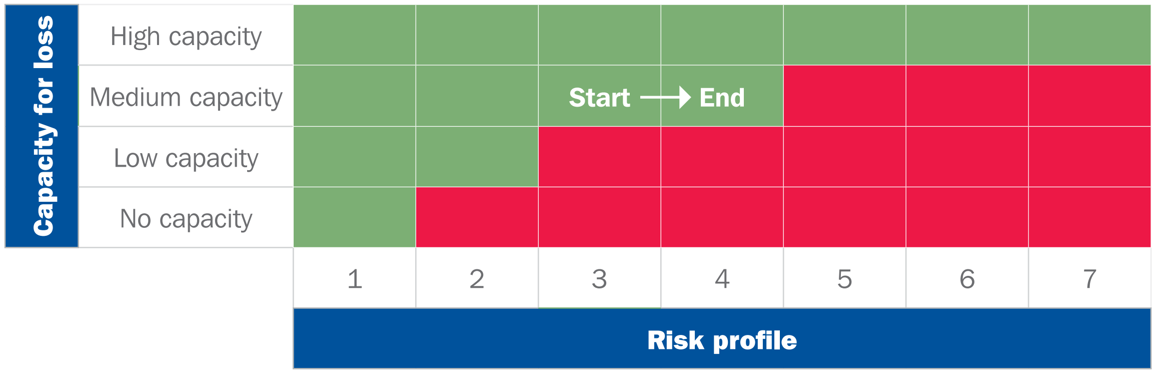
2a. Discuss compromises and trade-offs

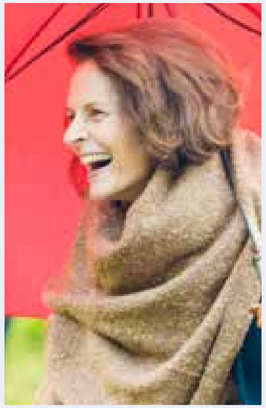
- increase time horizon
- reassess risk
- free up cash for investment
- re-assess retirement target income

Conclusion:

- After further discussions, Bill decides against working longer, and says he doesn't want to scale down his objectives.
- So you both agree that increasing his risk profile to a 4 is the best option.
- The decision to increase the risk Bill is willing to take is an important one. As a result your suitability report needs to clearly articulate the recommendation journey.

Recommendation:
Higher risk profile (4) agreed to meet client's objective.





Kirsty, 49

Your fact find assesses Kirsty as follows:

Risk level	Capacity for loss
2	High capacity

Kirsty's situation:

Kirsty plans to retire at 60 and go globe-trotting. She already has some savings, so her financial objective is relatively conservative, and should be sufficiently met by a risk-rated 2 investment. Although she has the capacity to take greater risk, she has no need to do so based on her current objectives. Capacity for loss shouldn't be used as a driver, and shouldn't be used to increase an individual's attitude to risk.

2. Can they meet their **objectives?**

No

Yes

Conclusion:

- using the grid you show and explain to Kirsty that her capacity for loss and attitude to risk appears appropriate to meet her current objectives.
- following your discussions, you recommend - and Kirsty agrees - to invest through a risk rated 2 investment.

Recommendation:

Risk profile kept at 2 in line with client's objectives.

Capacity for loss	1	2	3	4	5	6	7
High capacity		Start & end					
Medium capacity							
Low capacity							
No capacity							

Risk profile

Christopher, 52

Your fact find assesses Christopher as follows:

Risk level	Capacity for loss
5	High capacity

Christopher's situation:

Christopher has considerable wealth behind him, from inheritances and other successful investments. His objectives therefore feel comfortably achievable without the need to take unnecessary risks. Despite that, Christopher appears to have a high appetite for risk, coming out of your risk assessment as a 5.

2. Can they meet their **objectives?**

No

Conclusion:

- using the **capacity for loss framework,** you show Christopher he has a range of options from a risk profile perspective
- Your discussion could include the fact that he **doesn't need to take a high level of risk** to meet his objective
- Following these discussions Christopher agrees to a lower risk rated investment to achieve his objectives.
- As with Bill's example it is important to articulate the recommendation journey, i.e. why you have recommended and why Christopher has accepted investing in lower risk rated investments.

Yes

Recommendation:

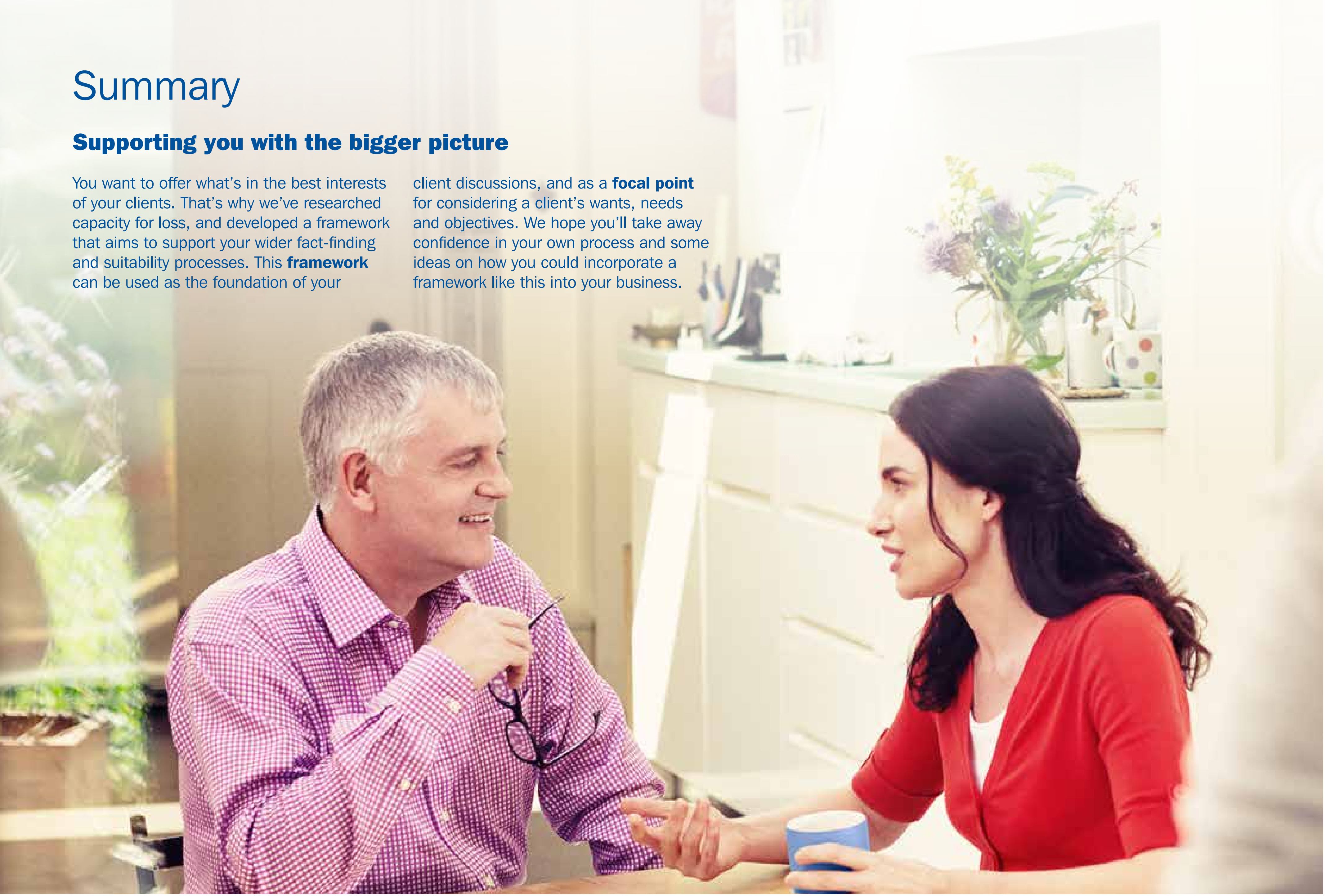
Risk profile lowered as client doesn't need to take excessive risk to achieve objective.

Capacity for loss								
	High capacity			End ←		Start		
	Medium capacity							
	Low capacity							
	No capacity							
		1	2	3	4	5	6	7
		Risk profile						

Summary

Supporting you with the bigger picture

You want to offer what's in the best interests of your clients. That's why we've researched capacity for loss, and developed a framework that aims to support your wider fact-finding and suitability processes. This **framework** can be used as the foundation of your client discussions, and as a **focal point** for considering a client's wants, needs and objectives. We hope you'll take away confidence in your own process and some ideas on how you could incorporate a framework like this into your business.



Here are some key takeaways from our capacity for loss framework:

1. **Help build a multi-levelled fact find**. Ensure that your fact find pieces together all the important factors that might influence your overall decision making. Does your fact find demonstrate that you've fully discussed, identified and explained your clients' 'willingness', 'ability' and 'need' to take risk to help reach their specific investment objectives?
2. **Tools are just the start of the process**. Whichever tools you use to support your capacity for loss discussions, you'll need to use them as part of a wider framework to support an accurate fact find and suitability report.
3. **Ensure you've incorporated common capacity for loss discussion themes into your fact find**. Whether you do this as part of your fact find discussion, or as a targeted part of the process, be clear on how you're finding out key information relating to capacity for loss. You could consider the themes highlighted in this paper as a starting point.
4. **Assess attitude to risk and capacity for loss in tandem**. Consider the results of these assessments together to help provide a fuller picture in your suitability report. Take a look at our 'visual' framework on pages 6-7 to see how you could help plot your client's risk rating against their capacity for loss. Having a framework allows you to consider wants, needs and objectives, in a structured way. It should act as the cornerstone to your process, helping you consider all the variables, and assess any trade-offs that are needed.
5. **Consider a visual framework to support your recommendations**. A framework provides structure, helping you illustrate your clients' situation through a common reference point.
6. **Document your clients' decision-making journey, in a clear and simple way**. A visual framework can help simplify the way you document your discussions and subsequent decisions.
7. **Ensure you have a process for monitoring investments to ensure they continue to meet clients' risk expectations**. Ongoing review of investments is key to ensuring adherence to their chosen volatility target. With a framework in place, you can quickly go back to your client recommendations to check on any changes to their personal circumstances or attitudes to risk.

Where does this capacity for loss framework research come from?

This capacity for loss framework is built on research carried out by **John Makin, Technical Consultant at AXA Wealth** during his successful studies as a Master of Financial Planning and Business Management at The Manchester Metropolitan University Business School.

John's dissertation, which builds on existing academic studies, received a distinction, while earning John the award of top performing student for his academic year on the MSc Financial Planning and Business Management Masters course.

The full name of John's study is: **Financial Planning: An empirical exploration of capacity for loss assessment (Makin AJ, December 2014).**

Find out more

- A selection of the source material used by John in his academic studies is detailed in the Appendix section of this document
- Our Retirement LifePlanning framework can be found at: axawealth.co.uk/adviser

Appendix

References and further reading

AJ Makin, 'Financial Planning: An empirical exploration of capacity for loss assessment', December 2014

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Further reading on key factors for assessing capacity for loss

Time horizon: Malkiel 1999; Cordell 2001; Cavezzali and Rignoli 2012

Dependents: Malkiel 1999; Cordell 2001; Cavezzali and Rignoli 2012

Income and expenditure (standard of living): Malkiel 1999; Cordell 2001; Cavezzali and Rignoli 2012

Health: Malkiel 1999

Net worth: Holzhauer 2010

Changes to financial circumstances: Malkiel 1999; FOS 2013

Insurance: Cordell 2001

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