Profiling risk in a volatile market

It's time to talk about capacity for loss

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Historic and current market uncertainty has brought into sharp focus the impact of volatility on people receiving their retirement income.

Here we discuss why the capacity for loss discussion and process, provides a valuable role in supporting better retirement outcomes for clients.

Risk assessment and capacity for loss

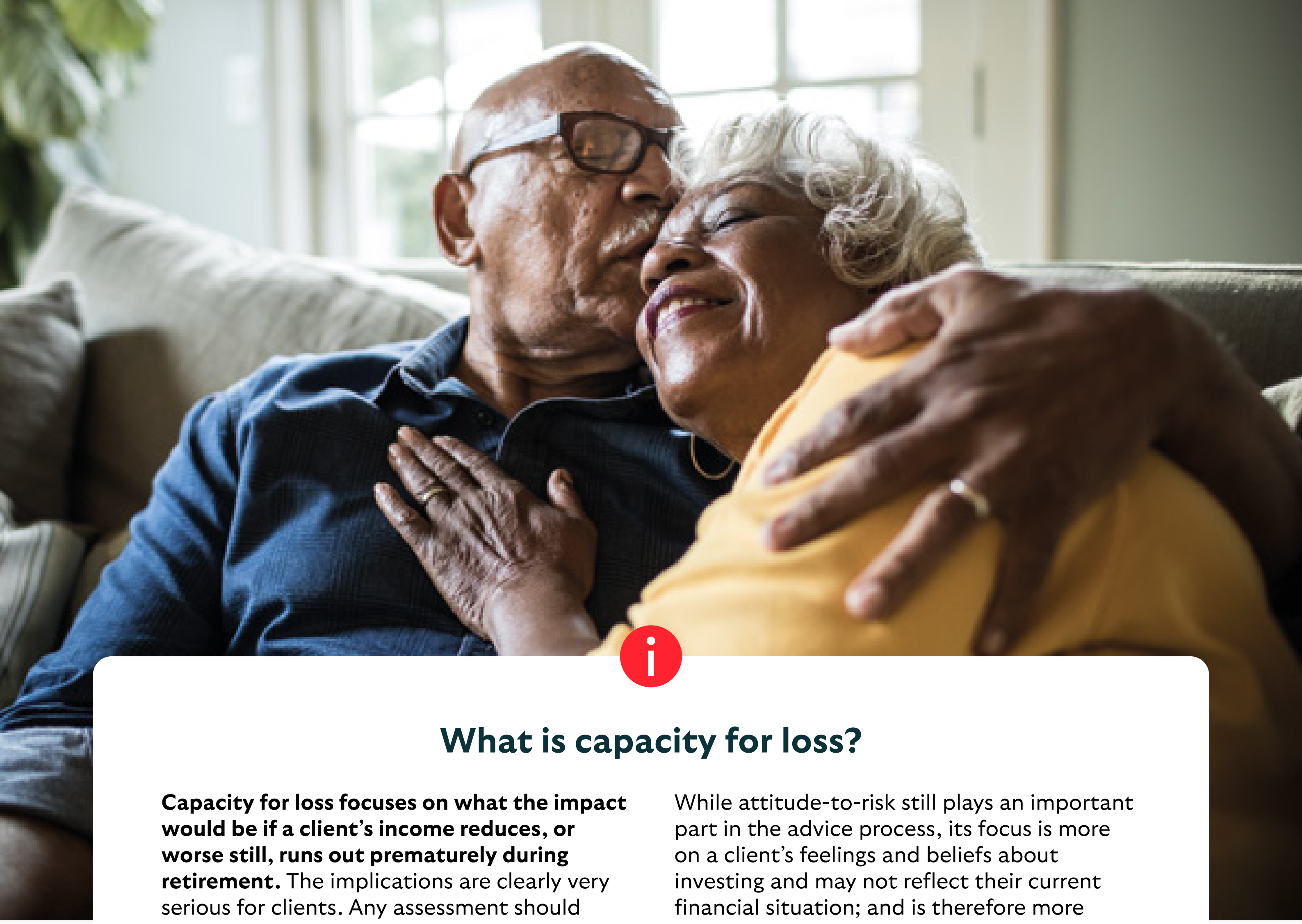
Capacity for loss has long been a focus for the regulator, with the FCA first raising the importance of assessing this in 2011. More recently, The FCA's Thematic Review of Retirement Income Advice emphasised the importance of assessing a client's capacity for loss when providing retirement income advice.

When devising a client investment strategy, advisers are accustomed to undertaking a detailed risk-profiling process to match needs to suitable investments. Often Centralised Investment Propositions (CIPs) are utilised to create a structured process that aims to be consistent, repeatable and to deliver suitable outcomes for client segments.

Whilst this works in accumulation, retirement income needs are often more complex. This means it's important to have a conversation about capacity for loss with clients who are approaching or already in retirement, where investment decisions will impact on the sustainability of their long-term income. This can form an important part of a Centralised Retirement Proposition (CRP) if adopted.

"When moving from accumulation to decumulation it is likely that the ATR and CFL for many customers will change, so needs to be reassessed. Recommended solutions should align with the customer's broader risk profile, taking into account their ATR and CFL."

Source: FCA TR24/1 Thematic Review of Retirement Income Advice



What is capacity for loss?

Capacity for loss focuses on what the impact would be if a client's income reduces, or worse still, runs out prematurely during retirement. The implications are clearly very serious for clients. Any assessment should consider the severity of this impact, which can help influence the level of risk a client feels they can take, and how secure their overall income needs to be.

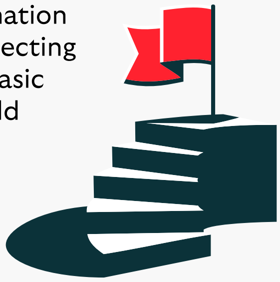
Assessing whether your client's lifestyle could withstand an income drop should take priority when providing retirement income advice.

While attitude-to-risk still plays an important part in the advice process, its focus is more on a client's feelings and beliefs about investing and may not reflect their current financial situation; and is therefore more subjective. This contrasts with capacity for loss, which attempts to assess financial facts and is more objective, with a detailed analysis of a client's expenditure (and likely expenditure) in retirement.

What is capacity for loss?

The starting point for assessing capacity for loss is an in-depth, comprehensive fact find, to thoroughly understand a client's expenditure now, and their future plans.

To objectively measure a client's capacity for loss, detailed information about income sources and expenditure plans are required. By collecting comprehensive fact-find details, many advisers are establishing basic cash-flow models that demonstrate a breakdown of the household budget and how it will change over time. Cash-flow modelling software packages can help here by bringing the concept of capacity for loss to life for clients by demonstrating different scenarios that show the impact of events and actions on finances at different points in retirement.



A ‘safety first’ approach – securing a client’s essential lifestyle

One way of approaching capacity for loss is the safety first approach, which makes sure the essentials a person needs are covered by their retirement income. This can be achieved by comparing how much secure lifetime income a client has (generally coming from three sources: occupational pension scheme, lifetime annuity or State Pension) versus how much income they need to cover the day to day essentials (items such as household bills or food).

If a client’s secure income doesn’t fully cover their essential expenditure, adopting a safety first planning method, means consideration is given to using some of a client’s available pension fund to buy additional secure income (such as an annuity). If the client’s secure income fully covers their essential expenditure, consideration can turn to more flexible solutions, which involve more investment risk.

Important in this planning process is the annual client review, which provides an ongoing opportunity to comprehensively reassess a client’s circumstances, income and expenditure and manage any potential shortfalls in their discretionary income.

In summary, capacity for loss (and the concept of CRPs) appear to be much less embedded in our industry, but can play a valuable role in retirement income planning. Capacity for loss should not be assessed in isolation, doing so alongside attitude to risk can help provide a more balanced view of clients’ retirement-income needs. An advice process involving both measures, as well as one that takes into account a client’s knowledge and experience of financial matters, gives context to a client’s financial situation and overall objectives. This will help advisers recommend a package of appropriate product and investment solutions for each individual’s retirement needs.

“A package of appropriate product and investment solutions for each individual’s retirement needs.”

How Scottish Widows can help

EVPro

The EVPro solutions, accessible through the Scottish Widows Platform, offer comprehensive suitability and capacity for loss tools.

The risk module delivers a client risk profiling solution, including various psychometric, behavioural, and knowledge-based questions, covering:

- Growth and income objectives – questionnaires to complete both accumulation and decumulation risk profiling.
- ESG questionnaire – a concise questionnaire to understand the importance of sustainable investing.
- Separate attitude to risk, knowledge and experience, capacity for loss, and sustainable investing outputs.
- Each area can be confirmed individually and summarised in an easy-to-understand report.

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