verve group

Capacity for Loss

THE NEXT CHAPTER

CONTENTS

SECTION ONE
Re-introduction
3

SECTION TWO
What does the regulator say?
4

SECTION THREE
What does this mean to advisers?
6

SECTION FOUR
How is capacity for loss assessed?
8

SECTION FIVE
How do I present capacity for loss to clients?
12

SECTION SIX
Summary
16

SECTION ONE

RE-INTRODUCTION

Hi, hello and welcome!

Yep, it's us at The Verve Group here... Last year Apricity released a guide on our favourite subject, capacity for loss (we're sure it's your favourite too). A year on and we thought we'd release a new guide, replacing our original guidance, reflecting The Verve Group's current stance. This encompasses how we look at capacity for loss and present it from a paraplanning perspective, all the way through to how we check a file from the compliance side. We have listened to advisers, the industry and our own staff on how capacity for loss works internally and want to share that with you.

Almost eleven years on from the regulator's guidance, we are still seeing descriptions of capacity for loss described as 'low/medium/high' which demonstrates a misunderstanding of the concept. And if we as financial planners don't know how to articulate it, how is it going to help clients?

We have developed the guidance in this paper by:

- looking at the regulator's guidance (yes there is some, albeit limited)
- taking feedback that we have received from you

then presenting all of that into a tangible guide for you to digest at your leisure.

Maddie Delboy
SENIOR REGULATORY SUPPORT

WHAT DOES THE REGULATOR SAY?

Capacity for loss is a term we hear all the time but the regulation for capacity for loss has actually been in place **since 2011**. Let's start with what the regulator ACTUALLY says about capacity for loss.

Firms should ensure that:

"They have a robust process for assessing the risk a customer is willing and able to take, including;

- Assessing a capacity for loss."

> This is a customer's ability to absorb falls in the value of their investment. If any loss of capital would have a materially detrimental effect on their standard of living, this should be taken into account in assessing the risk that they are able to take.
>
> THE FCA ON CAPACITY FOR LOSS

The FCA then go on to quote an example of good practice where they credit a firm who has a separate process to assess a customer's attitude to risk, and capacity for loss, ensuring they were both considered appropriately as part of the suitability assessment.

And that is about it...

We can look at the FCA Handbook (specifically **COBS 9.2 Assessing suitability**) for some more about the WHAT firms are expected to do.

The FCA often leave their guidance and rules fairly open, but this does not mean that they will hesitate to penalise a firm where they have not considered, and implemented, the guidance appropriately. Our job is to weigh the compliance requirement and the actual practicalities of how this is achieved.

> "A firm must obtain from the client such information as is necessary for the firm to understand the essential facts about him and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended, or entered into in the course of managing:
>
> (a) meets his investment objectives;
>
> **(b) is such that he is able financially to bear any related investment risks consistent with his investment objectives; and**
>
> (c) is such that he has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of his portfolio."

The guidance and rules from the FCA tell firms they need to do a capacity for loss assessment, but they don't go into any further detail, so it is our responsibility to stipulate what that looks like and how firms effectively demonstrate their clients' capacity for loss.

SECTION THREE

WHAT DOES THIS MEAN TO ADVISERS?

…financially bear any related investment risk consistent with his investment objectives.

THE FCA ON ASSESSING SUITABILITY

The focus here is **objectives**. One consistent stumbling block for an effective capacity for loss assessment is clear, long-term holistic objectives. We will later explore the different stages of a client's advice journey, accumulation and decumulation, and how this shapes the client's objectives; but regardless clear and appropriate individual objectives are needed.

Client objectives need to be clearly your individual **client's** objectives, not a generic objective you have in your suitability report that you have used to justify the recommendation. A client

objective needs to be the starting point of how you reach a suitable recommendation, tying in all of the other regulatory requirements and considerations.

We are all aware that all recommendations carry some risk. In our original guide we wrote that even cash carries risk - looking at inflation risk (at time of writing this revamped guide this now could not be more prevalent). This risk means that a capacity for loss assessment is relevant for all advice, the presentation is simply different depending on what stage in the investment journey we are looking at.

When we look at risk, we are looking at 3 things:

- Risk tolerance
- Need to take risk
- Capacity for risk/loss

Typically risk tolerance is nailed by advisers, there's ample supporting tools out there to help in this way and most advisers are comfortable talking to their clients about risk tolerance. Need to take risk, and capacity for loss are where advisers can become unstuck.

What about a scenario where the client objectives, their risk tolerance, their need to take risk and their capacity for loss conflict? Well, the FCA actually spell this out for us.

From a compliance perspective, we would expect to see evidence of this conflict and the subsequent conversations with the client documented on file. A lot of the conversations around the three elements of risk are there…in the adviser's head. We, and the regulator, require evidence on file. This can be in the suitability report, or documented in meeting notes. Anything supplementary to evidence how you reached a recommendation is so important for assessing suitability.

"In circumstances where a customer's needs conflict with the level of risk a firm has established the customer is willing and able to take, we expect the firm to have a detailed discussion with the customer. The firm should draw the customer's attention to any mis-matches in their investment objectives, financial circumstances, risk tolerance and capacity for loss. It should also explain the implications for the customer of making alternative trade-off decisions – for example, saving more, spending less, retiring later or taking more risk."

The FCA expect advisers and financial planners to understand these concepts, and pick up where there is a conflict.

SECTION FOUR

HOW IS CAPACITY FOR LOSS ASSESSED?

It was mentioned earlier that the presentation of capacity for loss is dependent on where the client is in their investment journey. Ultimately the impact of loss is more severe for a client as they approach (or are in) active decumulation, versus a client early in their accumulation journey. But this doesn't mean it is not important in those earlier stages.

We need to remember that capacity for loss is looking at the loss that can be experienced before a client's standard of living is breached. Standard of living, if we look at the FCA's DBAAT tool, is looking at a client's basic living needs. Their rent, their bills, their basic food needs. It is not looking at retirement holidays to the Maldives or a Netflix subscription (other streaming services are available).

If we consider a scenario of a 27 year old, regularly saving into their pension: they cannot access this pension for at least 30 years. If there was a market crash resulting in a 30% portfolio drop it would be extremely uncomfortable, but looking at the cyclical nature of markets, this is unlikely to have an impact on their overall financial plan. If you contrast this with a 65 year old who is just approaching retirement when that market crash happens, the outcome is very different.

This doesn't mean capacity for loss has no place in accumulation, it's just different.

Daniel Jones

AGE:
27

LOCATION:
BRIGHTON

OCCUPATION:
MARKETING EXECUTIVE

Janet Brown

AGE:
65

LOCATION:
BOURNEMOUTH

OCCUPATION:
ACCOUNTANT

Clients in accumulation.

Objectives, objectives, objectives. Clear, personalised, long-term, holistic objectives. There is no way that you can assess a client's capacity for loss without objectives. We appreciate that these objectives in accumulation are going to be long-term, and therefore subject to change. But that's the point of annual reviews and ongoing relationships. These conversations around desired outcomes should be renewed annually and the assessment updated as part of that.

The assessment presents a snapshot in time for that client, but you need to know what their aims are. And they may be looser than a client approaching decumulation, we appreciate and understand that, but people save for a reason and that needs to be demonstrated.

Soft facts are going to make up a large part of this assessment.

You should be considering, where applicable, the following and ensure they are documented on file:

- Timescale of the investment
- Impact of large losses on long-term objectives
- Difference between NEED to take risk, and risk tolerance

Just touching on the **need to take risk**, the best way to demonstrate this is to calculate a client's required return, or required contributions, in order to meet their access needs. This gives you (and the client) a tangible, monetary focus which, if we take a step back to the FCA's wording it; "allows you to make a subjective assessment of the impact" of the client not hitting their goals.

AS AN EXAMPLE:

- You would like to retire at age 60 and anticipate you would like a gross income of £30,000 per annum, from a combination of state pension and personal pensions.
- We have calculated that to sustain this level of income from aged 60 you will require a fund value in excess of £600,000.
- We have calculated that in order to reach this you require a 3% per annum minimum growth rate. *need to take risk*
- Using a growth rate of 5% per annum, based on your balanced risk profile *risk tolerance* and your current contributions of £20,000 gross per annum, your projected fund value at retirement is £750,000.
- With your risk tolerance higher than your need to take risk, you demonstrate the capacity to withstand periods of investment underperformance.

Without the objectives of the desired retirement age and income need, this assessment is impossible. Clear, documented, objectives are vital throughout. Use your skills as a financial planner to edge those objectives out of clients and ensure they are documented and on file.

Cash flow modelling in any recommendation, but particularly in accumulation, is not mandated but the assessment is much easier when you use these tools to support your assessment.

Clients who are approaching, or are in, decumulation.

Objectives, objectives, objectives. Clear, personalised, long-term, holistic objectives. Can you spot the difference? Nope? That's because there isn't one. Okay, so potentially 'long-term' isn't as applicable as the income need is likely to be imminent, but hopefully the message is starting to become clear.

As mentioned earlier, the implication of loss on clients who are approaching (or are at) decumulation, is greater. This means that firms need to have a far more robust assessment of these clients' capacity for loss.

The answer? **Cashflow modelling**.

The sophistication of the majority of these cashflow modelling tools now means that, if you can plug in your client's personalised objectives and their expenditure, the tool will do the work to spit out the capacity for loss assessment. The results will tell you in monetary and/or percentage terms how much the client can afford to lose before their standard of living is impacted.

Remember, as well as looking at the client's objectives, you need to gather information on their spending. As a client is approaching decumulation, they will need know their cost of living, be this just their basic cost of living, or their desired lifestyle spending. Advisers, you need to ensure you are gathering this detailed information so that you can assess the loss that can be experienced before this becomes unaffordable.

The industry needs to move away from standardising capacity for loss assessments. One client's low is another's high. With these tools, at least a monetary or percentage term should be presented on file.

We know not all cashflow modelling tools are the same. If your cashflow modelling tool does not have a specific capacity for loss model, then create one. Create different scenarios of market decline. You can do this in 5% to 10% stages, and you will soon see where the client cannot afford their standard of living anymore.

We appreciate the FCA does not mandate the use of cashflow for this assessment, but do encourage this as best practice and feel it is the easiest way to demonstrate capacity for loss. For those who do not wish to use cashflow software, we see some advisers use spreadsheets instead of cashflow, which is absolutely fine, you just need to evidence your assessment on file.

For clients who are five years from decumulation, or in active retirement, we would recommend cashflow modelling for all cases.

SECTION FIVE

HOW DO I PRESENT CAPACITY FOR LOSS TO CLIENTS?

Clients engage with cashflow modelling… it's visual, it's engaging and it's not a 50-page suitability report. There is a place for capacity for loss in the suitability report, but it doesn't need to be complicated. Summarise the client's investment position (their assets), income needs, standard of living cost, and conclude with the capacity for loss assessment.

AS AN EXAMPLE:

- You hope to retire in two years' time.
- Your normal annual expenditure is £27,000 and this includes your essential living costs (rent, food, bills etc) of £12,000 and discretionary spending (socialising, entertainment etc) of £15,000.
- You have £30,000 held in your cash savings, this includes your emergency fund of £15,000, but you'd also like to use this money to cover the costs of your holidays over the next 5 or so years. You imagine this will cost an additional c. £2,500 per annum on top of your normal spending.
- You have £285,000 invested in your stocks & shares ISA and £410,000 in your pension pot.
- Your state pension will commence when you reach age 67.

Based on the above information, our calculations show that if your ISA and pension were to experience an additional loss of -36% next year, you may potentially run out of money when you reach the age of 90 (see Figure 1).

NB: The figure of 36% is used in this example as this is based on the worst market crash historically experienced.

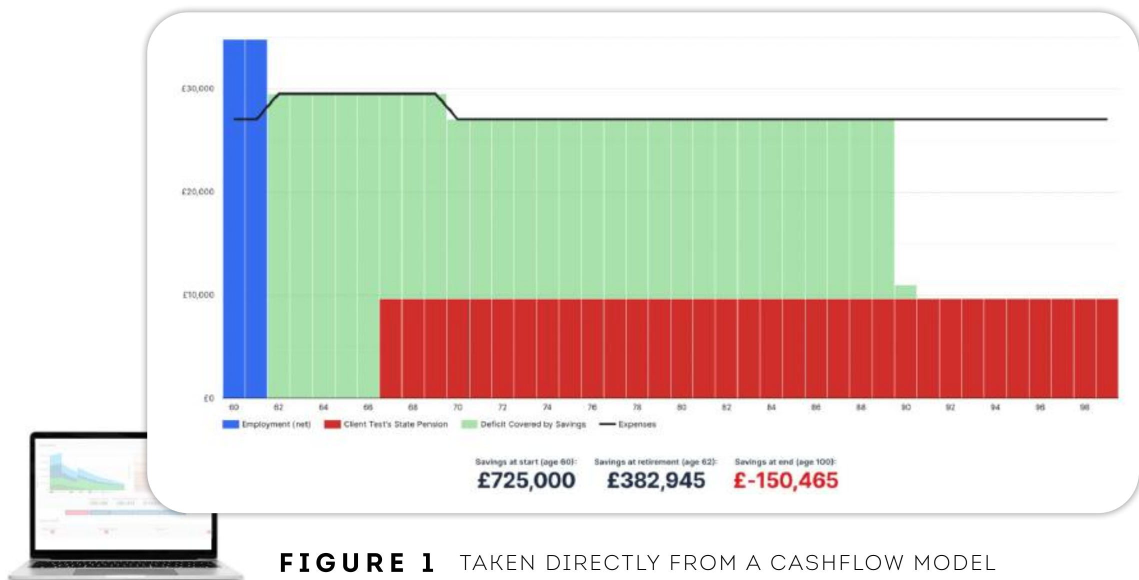

FIGURE 1 TAKEN DIRECTLY FROM A CASHFLOW MODEL

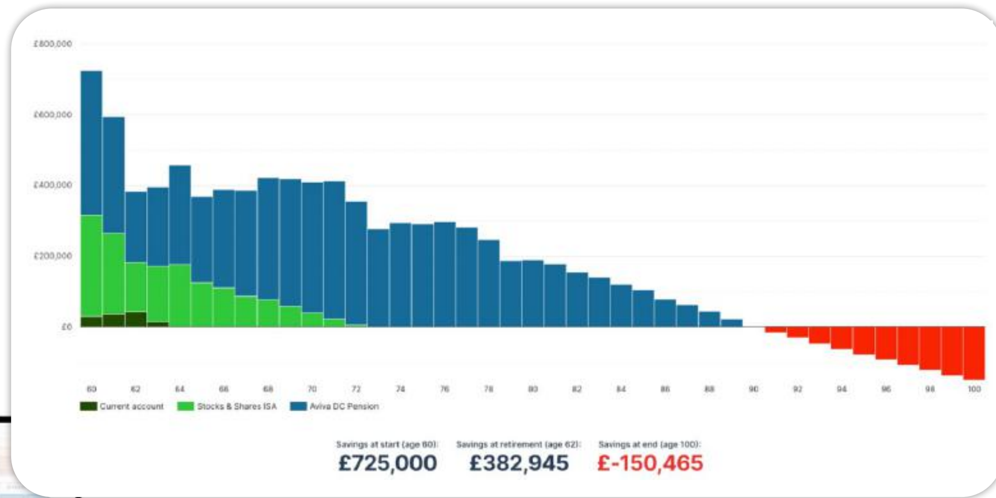

FIGURE 2 TAKEN DIRECTLY FROM A CASHFLOW MODEL

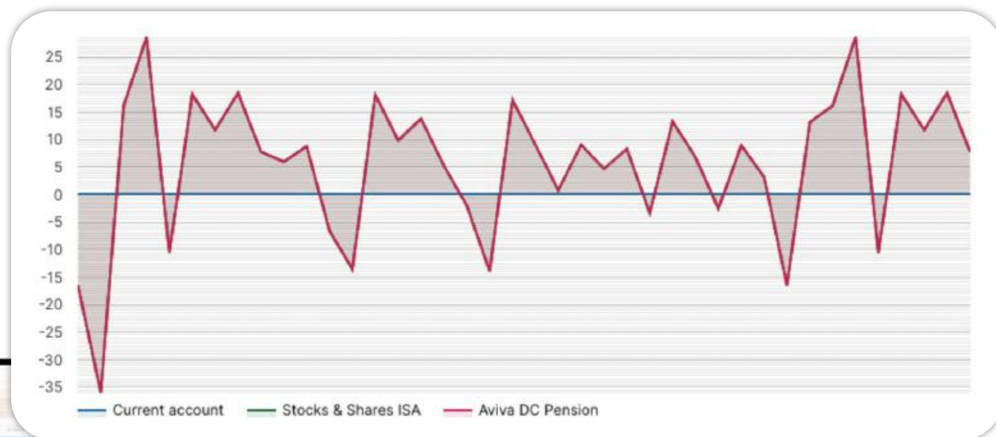

FIGURE 3 TAKEN DIRECTLY FROM A CASHFLOW MODEL

The black line in figure 1 represents your spending. As you can see, we have assumed that your expenditure will remain the same throughout your retirement, and this includes your discretionary spending of £15,000. We've discussed how you'll likely spend less when you get older, and you'd rather spend more while you're fitter and younger. We will look to review your cashflow every year and keep on top of this with the value of your investments (see figure 3) and your discretionary spending.

If we were to look at cutting out your discretionary expenditure and focus solely on making sure that you

have enough to make ends meet, the forecast suggests that you will have sufficient assets and have the capacity to withstand this additional market fall of 36%.

It's important to note that our calculations are based on a number of assumptions and are by no means guaranteed. However, we have assessed your capacity for loss and believe that you have enough capacity to invest within your balanced risk profile (see figure 4).

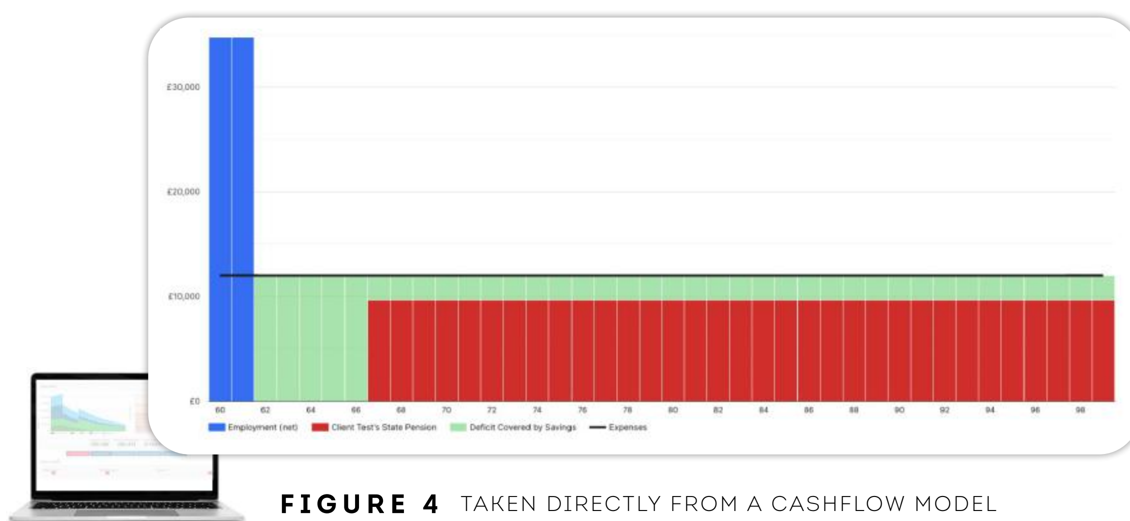

FIGURE 4 TAKEN DIRECTLY FROM A CASHFLOW MODEL

OTHER ASPECTS TO CONSIDER.

Firms need to ensure there is a consistent approach across all their advisers. All cashflow software is slightly different, so ensure that the same is used as standard, and assumptions are set at a firm level.

You should also consider which scenarios are suitable. You could look at:

- Market crash scenarios
- High inflationary periods
- Risk of death
- Care home fees

One thing advisers and clients need to grasp is the capacity for loss assessment is a snapshot. The whole point of advisers offering ongoing reviews, and reassessing suitability, is to renew these conversations annually to ensure their plan is on the right track.

SECTION SIX

SUMMARY

There we go!

The guidance from the regulator is light, but the expectation for the demonstration of capacity for loss within a client file is clear. Firms' interpretation and implementation of 'how' they do this is going to differ, but what we can all agree is it needs to happen.

In both guides we started with the FCA's expectations, and we've concluded in the same way, because it's so important:

A firm must obtain … such information … that the specific transaction … recommended… is such that he is able financially to bear any related investment risks consistent with his investment objectives.

THE FCA ON CAPACITY FOR LOSS

This all comes back to the p word. **Process**. Firms need to have an internal process on demonstrating capacity for loss in a file and ensure all relevant staff are trained appropriately. Some things to think about as part of that process and training in your firm:

- Have you mandated the use of cashflow?
- Are all staff trained?
- Are all staff using the same assumptions?

The process doesn't start and stop at the output of a capacity for loss assessment, however. Advisers and paraplanners need to be able to obtain relevant, detailed information in order to create a financial plan. Objectives need to be long-term, holistic and personalised to that client, otherwise you could end up with a very generic document - exactly what the FCA think is inappropriate evidence.

Capacity for loss has been circling for eleven years and the industry has developed in so many ways during this time. The technology available at the moment is incredible, and cashflow modelling can help the financial planner clearly demonstrate that capacity for loss assessment.

We hope that this guide has cleared up any misunderstanding of the term capacity for loss and has provided you with the language to help explain the concept to clients more clearly. Fingers crossed that we have shown the need for clear, documented evidence that capacity for loss has been considered and assessed fully as part of your recommendations, which will eventually lead to better outcomes for all.

Please **get in touch** if you want to share your thoughts on the topic, or browse more useful information on our **website**.

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