



Assessing capacity for loss

For financial adviser use only.

This document should not be distributed to, or relied upon by, retail clients.

Standard Life





Standard Life white paper — Understanding the unique nature of capacity for loss

We've all become very used to undertaking a detailed risk profiling process in order to match clients to suitable investments. However, feedback from advisers is that the assessment and documentation of a client's capacity for loss has proved challenging. There was a time when attitude to risk was the primary focus for advisers and much has been written and debated about how that should be assessed; less so about capacity for loss assessment. The FCA has recommended assessing a client's capacity for loss alongside attitude to risk for many years, and it is a message that is frequently repeated by the regulator.

This white paper is here to support you in your discussions with clients during the fact find process. It will help you to explore the concept of loss with the client and demonstrate the significance of considering capacity for loss alongside attitude to risk. It is based on research I've carried out: I believe it will help you in setting appropriate objectives for your clients and assist you in building accurate suitability reports. At the end of this white paper, I suggest further reading for assisting you in assessing capacity for loss.

Thank you,

A handwritten signature in black ink, appearing to read 'J Makin', written in a cursive style.

John Makin
Senior Technical Consultant,
Standard Life Aberdeen group

The Regulator's position

The Financial Conduct Authority (FCA) stressed the importance of assessing capacity for loss in its April 2017 Guidance Consultation document. However, this is not a new concern – the previously known Financial Services Authority first raised concerns around this area back in 2011.

The 2017 Consultation document is based on feedback from the advice sector: the FCA wrote to some 700 firms in 2016 to gather data for a review of its guidance on suitability reports, amongst other areas. In the Guidance, the Regulator is very specific about the need for assessing capacity for loss:

“When considering a customer’s attitude to risk as part of assessing suitability, the client’s capacity for loss (the client’s ability to absorb falls in the value of their investment) should also be taken into account. 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”

FCA Guidance Consultation, April 2017. (GC17-04)

However, our research indicates that this is still an area which causes confusion for the advice sector. There appears to be some uncertainty around the assessment and documentation of capacity for loss, and its integration into the process of building an overall investment recommendation. This view is further supported by the FCA’s Wealth Management firms and private banks suitability of investment portfolios thematic review.

Poor Practice

“Many firms within our sample had failed to demonstrate from the information on file whether they had considered a customer’s capacity for loss.”

FCA’s Wealth Management firms and private banks suitability of investment portfolios thematic review. (TR15-12)

What is the difference between attitude to risk and capacity for loss?

With attitude to risk we’re dealing with the client’s mindset - with feelings and beliefs.

These may or may not reflect their current financial situation and will be influenced by many factors. Assessment of attitude to risk involves a psychometric approach, with questions such as ‘how do you feel about...?’. Attitude to risk is therefore subjective in nature and this contrasts with capacity for loss which is objective in nature.

Capacity for loss is a much more scientific measurement. It assesses facts - taking the real numbers around a client’s financial situation and testing them against the client’s ability to absorb falls in value and the impact this will have on their standard of living. It’s really what will happen if things don’t go to plan. Determining capacity for loss is particularly important for clients approaching or already in retirement, where investment decisions will impact on sustainability of their long-term income requirements.

Attitude to risk outcomes are driven by the client based upon the answers they provide to the attitude to risk tool used by the advisory firm. This represents the level of risk the client is willing to take and contrasts with capacity for loss where the outcome is driven by the adviser, using their skill and judgement, to define the level of risk that a client is able to take.

Assessing capacity for loss

The fundamental starting point for assessing capacity for loss is an in-depth, comprehensive fact find. It's about thoroughly knowing your client – the fact find underpins every element of the advice process. Good fact finding should ensure you achieve good client outcomes.

The nuts and bolts

As advisory firms work within a principles-based regulatory system, there are no set rules as to how capacity for loss should be assessed. Assessing capacity for loss can be achieved using a number of methodologies and tools. Two potential approaches are:

- ▶ **Cash flow modelling** – there are a number of software packages on the market that provide flexible and versatile ways to demonstrate the impact of events and actions on the client's finances at different points in time. These tools can be suitable for demonstrating capacity for loss as they allow different scenarios to be explored.
- ▶ **Capacity for loss questionnaires** – these can help you assess capacity for loss with your clients. On page 6 we provide a useful guide with a number of discussion themes which could be considered when assessing an individual's capacity for loss.

Whatever approach you use, it is important that your assessment is part of a wider discussion with clients that also looks at their attitude to risk, their knowledge and experience of financial matters. These factors should then be put into the context of the client's financial situation and their overall objectives.

The most important point to make is that capacity for loss and Attitude to Risk should be separately assessed and separately documented in your suitability reports to demonstrate that you have made a clear distinction between the two measurements.

However, attitude to risk and capacity for loss should never be assessed in isolation; you need both assessments in order to get a balanced view of your client. Only then can you build a truly suitable investment solution based on your client's situation.



The capacity for loss discussion guide

John's research identified key areas for discussion that would assist with assessing the client's capacity for loss. We've taken these central themes and incorporated them into the sample discussion guide to give you a starting point for your own assessment process.

A discussion guide can be used to steer and document what is discussed with the client, becoming a key element in your client record. We've provided this sample but there are subjective areas that you will need to consider. For example, you will need to set out clear parameters for the no/low, medium and high capacity ratings within your firm's procedures, or agree a different scale if indicated by your internal procedures.

If you have a guide such as this, to assess capacity for loss, you can measure your initial assessment against future changes allowing for a consistent and repeatable process.

Potential discussion themes when investing for income/capital		
1. How long does your client plan to hold this investment before they start taking an income/capital from it?		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>
2. How much would your client's standard of living be affected if the income from their investments were to fall below their expectations?		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>
3. If your client needed immediate access to a lump sum, how likely would your client be to take it from this investment?		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>
4. Approximately how much income does your client have remaining each month, after all monthly expenditure?		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>
5. Does your client 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)		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>
6. Does your client anticipate any changes to their current financial circumstances? e.g. any potential inheritance		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>

7. Is your client able to save on a regular basis without affecting their standard of living and if so, how much would they be able to comfortably save?		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>
8. Is your client in good health? (capacity to earn)		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>
9. How knowledgeable is your client on investments and risks? (capacity to understand investment risk)		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>
10. How many dependents in your client's family, besides themselves, do they fully or partially support? (capacity to impact standard of living)		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>
11. Insurance can cover a wide variety of life's major risk: theft, fire, accident, illness, death. How much cover does your client have?		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>
12. Think of your client's net worth as being what they own. This includes their family home and other personal use assets, minus what they owe. What is the value of your client's net worth? (Please include only their share of jointly owned assets).		
Notes:		
No/Low capacity <input type="checkbox"/>	Medium capacity <input type="checkbox"/>	High capacity <input type="checkbox"/>

Please note: The discussion guide has been prepared as a sample guide for advisers and is for information only. It is not intended to satisfy all the regulatory and compliance responsibilities owed by advisers to their clients, nor is it intended to replace existing compliance and due diligence processes.

Advisers should satisfy themselves as to the appropriateness of this document for the client's purposes. This discussion guide is used at advisers' own risk and no responsibility is accepted by Standard Life for any problems caused by reliance on, or use of, this document. Standard Life do not recommend that advisers pass this document on to clients. Standard Life do not recommend that this document is used by anyone who is not a financial adviser' regulated and authorised by the Financial Conduct Authority in the United Kingdom.

Reconciling attitude to risk and capacity for loss

As part of John's research, he developed a grid to assist in identifying whether there is a conflict between your assessment of the client's attitude to risk and their capacity for loss. The orange boxes indicate potential conflicts: if your client falls into an orange box, you may need to discuss their risk ratings and how it aligns with their objectives.

Risk profile / Capacity for loss	1	2	3	4	5	6	7	8	9	10
No/Low capacity										
Medium capacity										
High capacity										

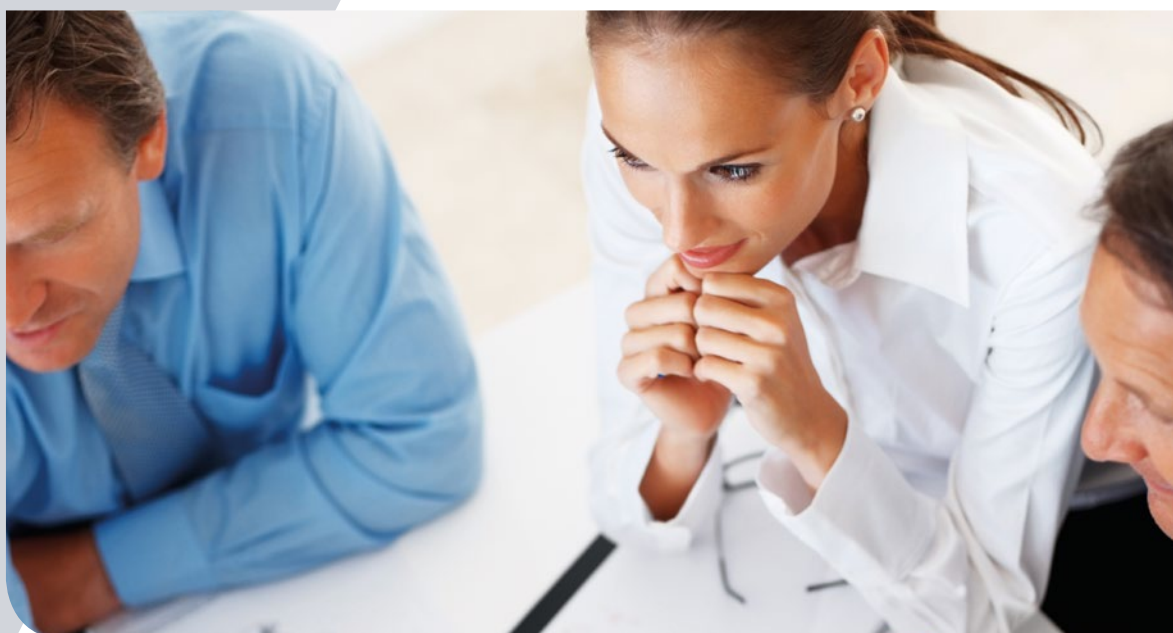
Measuring and scoring

Risk Profile – we have used a hypothetical risk scale with scores of 1 to 10 where 1 is the lowest and 10 is the highest. You can simply transpose your own scale onto the grid depending on which attitude to risk tool you use within your business.

Capacity for loss – we're assessing capacity for loss as follows:

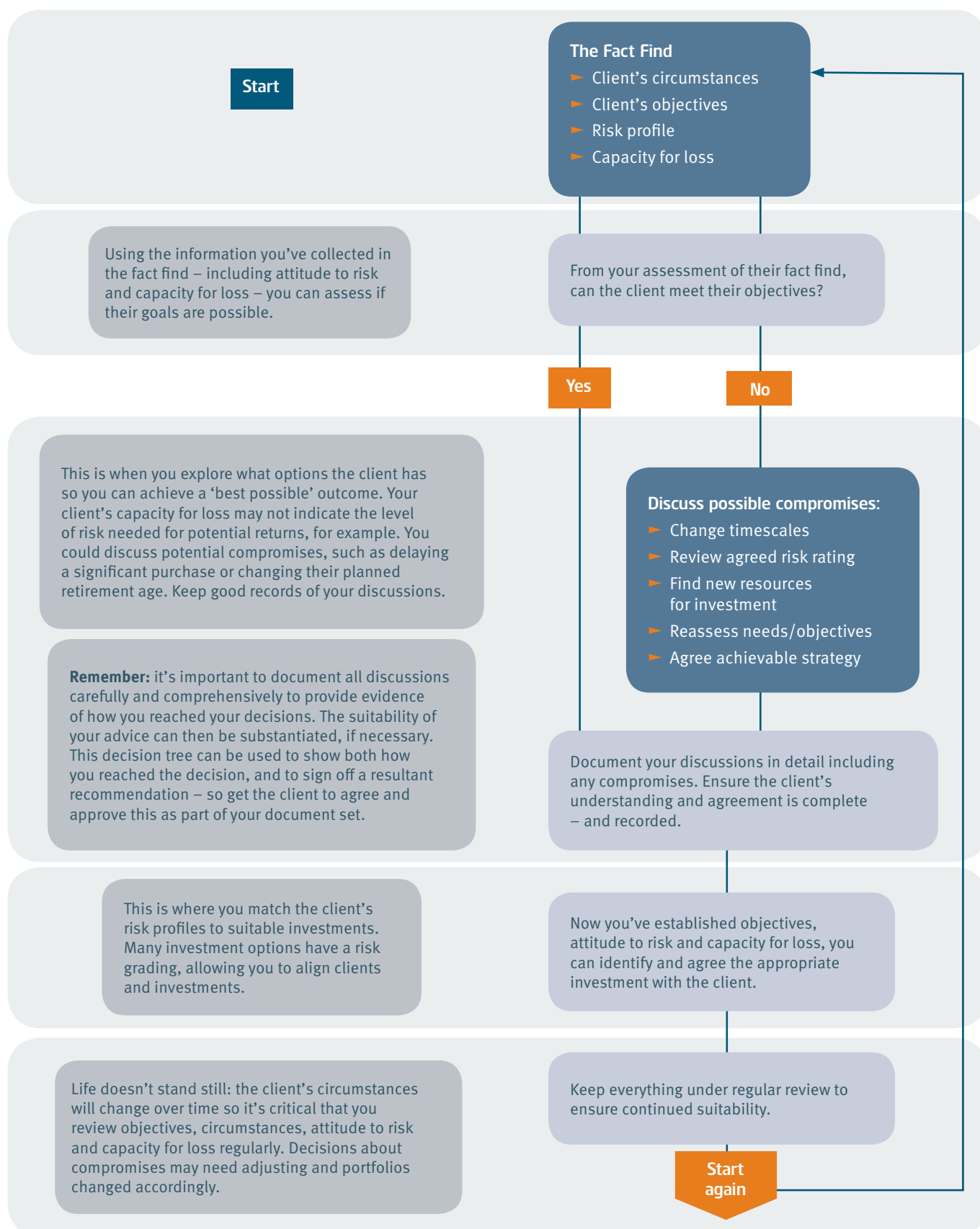
- ▶ High capacity
- ▶ Medium capacity
- ▶ No/Low capacity

Other capacity for loss tools and scales are available and can be used in the same way.



Capacity for loss structure

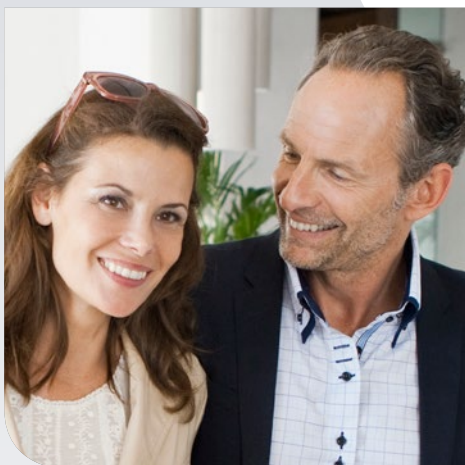
We appreciate that you want to offer what is in the best interests of your clients. That's why we've researched capacity for loss, and developed a structure that aims to support your wider fact-finding and suitability reporting processes. This structure can be used to develop your own process, which you may choose to use as the foundation of your client discussions, and as a focal point for considering a client's wants, needs and objectives.



Please note: This structure is for information only. It is not intended to satisfy all the regulatory and compliance responsibilities owed by advisers to their clients nor is it intended to replace compliance and due diligence processes.

Case studies

Here are some examples on how capacity for loss can impact your fact find and suitability report. Please use the capacity for loss structure and consider these examples:



Case study 1 - high attitude to risk but medium capacity for loss

Paul, 57 and Sharon, 54

Paul and Sharon have a high standard of living as they have invested wisely over the years. They believe this will continue during their retirement, without needing to consider any changes to their existing investment portfolio.

They are a married couple and have been married for 22 years with a son, James, aged 15.

Both have had successful careers and benefitted from being members of final salary schemes. Both of them recently transferred their final salary schemes into SIPPS, leaving them with an overall pot of £1.3m between them.

They also have other investments worth £120,000 that they can rely on when considering their retirement. Their financial goal is that when Paul reaches 60 they will both retire, as this coincides with the end of their

mortgage. They also hope to help their son on the property ladder when the time comes.

They arranged a meeting with their adviser to review their investment strategy, taking into account their plans for retirement and the financial needs of their son, when he is older. When it comes to risk they have both benefitted from strong growth in equities and good dividend income.

- ▶ They are both healthy and see themselves living well into their 80s, based on their current health and lifestyle
- ▶ Their attitude to risk is quite aggressive as they see themselves investing for the long term
- ▶ When challenged by their adviser on their capacity for loss, they initially thought it wasn't anything that concerned them.

Their adviser asked them to consider the impact on their income and long term aspirations if their investments were to suffer losses.

- ▶ What would be the impact on helping their son purchase his first property?
- ▶ What kind of retirement would they have if their investments suffered some loss?

After completing the capacity for loss discussion guide and using a risk questionnaire it was apparent that whilst Paul and Sharon did have a strong willingness to take risk this was not fully matched with their ability to suffer investment loss which could have a detrimental impact on their standard of living. After a discussion with their adviser it was agreed that they have a medium capacity for loss.

They also agreed that they should reconsider what investment risk they would be comfortable with, when considering potential losses. It was agreed to change the risk profile from risk level 9 to risk level 6.

To recap

1. Paul and Sharon now realise that they have a lower capacity for loss than they had originally realised.
2. They agree to amend their risk profile to reflect this.

Risk profile / Capacity for loss	1	2	3	4	5	6	7	8	9	10
No/Low capacity										
Medium capacity										
High capacity										

← Paul and Sharon

You document the reason for the change in their client suitability report.



Case study 2 - low attitude to risk but high capacity for loss

Stephen, 62 and Susan, 62

Stephen and Susan are typical baby boomers and have been married for 40 years. Their children are grown up and are financially independent.

On a number of occasions they moved house and benefited from sharp increase in prices. They both plan to retire next year and have recently downsized.

Susan has a final salary pension of £18,600 p.a. that they will use to pay the essential bills for the rest of their lives. Stephen has benefited from both defined benefit & defined contribution pensions and amalgamated both recently, giving him a total defined contribution pot of £1.1m.

From the sales of their parents' homes they have inherited over £400,000. Over the last few years they have made a number of gifts to their children, grandchildren as well as to several charities. They have a

clear goal of leaving as large a legacy as possible to their family and charities that they support.

On the basis of their wealth they decided to seek advice.

Stephen and Susan said;

- ▶ They have basic financial awareness so therefore are not keen on taking too many risks

Their adviser explained to them that although they don't wish to take risks, they should still consider a number of other factors;

- ▶ The net effect of inflation on their savings based on current interest rates.
- ▶ Had they thought about the potential for long term care as they got older and the associated costs of that? Does their capacity for loss take this into account?

Stephen and Susan together with their adviser completed the capacity for loss discussion guide which identified that they had a high capacity for loss due to excess savings beyond their income requirements.

They also completed a risk questionnaire which showed that they had a very low attitude to risk. Their adviser then explained that a strategy which appeared to avoid taking investment risk could become a source of risk in itself if growth on their savings failed to keep pace with inflation.

So they agreed with their adviser that a small increase in risk level may be a better way to meet their goals.

To recap

1. They understand the benefit of taking some risk. They agree to move to risk level 3.
2. Their low attitude to risk means that they may not be achieving their maximum potential investment returns.
3. They have a high capacity for loss and have scope to take some more investment risk without impacting on their standard of living.
4. The regulator is clear that the risk level of a client should not be increased based solely on high capacity for loss. However, this is acceptable as long as the client fully understands and accepts that they are increasing risk to meet their objectives.

Capacity for loss \ Risk profile		1	2	3	4	5	6	7	8	9	10
		No/Low capacity									
Medium capacity											
High capacity											

Stephen and Susan →

You document the reason for the change in their client suitability report. You encourage them to have an annual review so that you can discuss future financial goals such as long term care.



Case study 3 - high attitude to risk but high capacity for loss

Sally, 25

Sally is a graduate and started her first job a few years ago. She has already been investing in her pension fund as she was auto enrolled into a workplace pension. Her grandparents have also invested money for her. She is planning to retire at age 60, in 35 years' time.

She likes to keep track of her investments online and she doesn't get too nervous when the value fluctuates as she understands that her investments are for the long term. As it will be a long time before she retires the time horizon results in a high capacity for loss in respect of this objective.

Using the capacity for loss discussion guide you have decided she currently has a high capacity for loss in respect of her objective of funding an income in retirement.

Using a risk questionnaire you assessed her at risk level 7.

To recap

1. Sally has a high attitude to risk and understands that fluctuations in the market can impact investment in the short term but that she is investing for the long term.
2. Sally currently has a high capacity for loss in respect of the objective of funding an income in retirement.
3. Short term volatility in the pension fund is unlikely to impact on her standard of living today as the pension fund cannot be accessed for at least 30 years. Any investment volatility could potentially benefit from pound cost averaging.
4. Any other objectives that Sally may have might result in a different, potentially lower, capacity to bear loss.

Risk profile / Capacity for loss	1	2	3	4	5	6	7	8	9	10
No/Low capacity										
Medium capacity										
High capacity							● Sally			

You document in Sally's client suitability report that you both agree no changes should be made and you will discuss again at the annual review meeting.



Points to remember

This capacity for loss white paper gives you the structural elements to integrate capacity for loss into your risk profiling process. Here are our top ten points to remember:

1. The fact find provides you with the foundation for building suitability. Make sure yours is comprehensive and clear.
2. Understand the difference between the client's willingness to accept risk (attitude to risk) and their ability to withstand it (capacity for loss).
3. Assess attitude to risk and capacity for loss separately but consider the results in tandem. Although they are very different, you should never recommend on the basis of just one of them, both should be seen as equally important.
4. A suitable recommendation is one that meets the client's objectives. If attitude to risk and capacity for loss indicate the objectives can't be met, then something has to change. Discussion and documentation is key.
5. Tools are useful but not the complete answer. Questionnaires and cashflow modelling provide useful data and discussion points, but must be seen as part of the wider client picture.
6. Consistency in your procedures to assess capacity for loss is critical. Be clear about what information you need and how you will collect and analyse it. Our white paper can give you a structure if you need it.
7. Use visual tools - such as the graphics and charts in this white paper - to reconcile your attitude to risk and capacity for loss results and support your recommendations when talking to the client.
8. Keep careful, clear records. You need to ensure that you have documented every step of the client's decision-making process. Using visual tools can help you do this in a clear and simple way. Get the client to agree and approve what you've recorded.
9. Monitor investments and portfolios to make sure they continue to be aligned with the client's risk profile and capacity for loss.
10. Monitor changes in the client's circumstances or risk profile. Return to the suitability decision again and again to make sure it is still valid for the client's current circumstances.





Further reading

This white paper is built on research carried out by **John Makin, Technical Consultant, Standard Life Aberdeen group**, during his successful Master of Financial Planning and Business Management studies at The Manchester Metropolitan University Business School. If you would like a copy of John's dissertation please contact us.

Financial Conduct Authority (FCA) - Guidance consultation document - April 2017

Cash, J (2015) - FCA urges advisers to be clear about capacity for loss
<http://citywire.co.uk/new-model-adviser/news/fca-urges-advisers-to-be-clear-about-capacity-for-loss/a855003>

Moitra, E (2015) - Drawdown danger: don't gamble on clients' capacity for loss
<http://citywire.co.uk/new-model-adviser/news/drawdown-danger-dont-gamble-on-clients-capacity-for-loss/a796658>

Fyer, N (2017) - Project fears: how client goals should shape approach to risk
<http://citywire.co.uk/new-model-adviser/news/project-fears-how-client-goals-should-shape-approach-to-risk/a1001484>

Norman, T (2014) - FCA: Industry does not understand capacity for loss
<https://www.moneymarketing.co.uk/fca-industry-does-not-understand-capacity-for-loss/>

Checklist

Use this checklist to ensure you have integrated capacity for loss into your risk profiling processes. Applying this white paper to your wider fact finding process can help you get there.



I understand the difference between attitude to risk and capacity for loss



Capacity for loss is covered separately in our fact find process



I discuss this area with my clients at every review and document the discussions accordingly



I am comfortable that I have the right tools to assess capacity for loss and discuss it with my clients



I am assessing both my clients' attitude to risk and capacity for loss and I am looking at both sets of results before building a recommendation.

Please get in touch if you require further information

Your usual contact will be able to help you.

As part of our commitment to quality service and security, telephone calls may be recorded.
Call charges will vary.

Please be aware that emails are not secure as they can be intercepted, so think carefully
before sharing personal or confidential information in this way.